H.R. 5302, SMALL BUSINESS VENTURE CAPITAL ACT OF 1981

HEARING

BEFORE THE

SUBCOMMITTEE ON TAX, ACCESS TO EQUITY CAPITAL AND BUSINESS OPPORTUNITIES

OF THE

COMMITTEE ON SMALL BUSINESS HOUSE OF REPRESENTATIVES

NINETY-SEVENTH CONGRESS

SECOND SESSION

WASHINGTON, D.C., MARCH 24, 1982

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CONTENTS

	Page
Hearing held on March 24, 1982	1
Opening statements of:	
Marriott, Hon. Dan, a Representative in Congress from the State of Utah.	8
Nowak, Hon. Henry J., chairman, Subcommittee on Tax, Access to Equity Capital and Business Opportunities	1
H.R. 5302	2
Panel consisting of:	
Rider, Brent T., accompanied by Walter Stults, and Peter McNeish; and Donald A. Ross	33
Testimony of:	
Holloway, Edwin T., Associate Administrator for Finance and Investment, Small Business Administration, accompanied by Robert Lineberry, Acting Deputy Associate Administrator for Investment Division, and John L. Werner, Director of Program Policy Evaluation Staff	9
Kemp, Robert, president, Opportunity Funding Corp., and Fulcrum Venture Capital Corp., Washington, D.C., accompanied by JoAnn Price, vice president, American Association of MESBIC's	75
Koldyke, Martin, director, National Venture Capital Association, and general partner, Frontenac Co	82
Rider, Brent T., president, Union Venture Corp., Los Angeles, Calif., and chairman, NASBIC, accompanied by Walter Stults, president, and Peter McNeish, vice president, NASBIC	33
Ross, Donald A., president, Rand Capital Corp., Buffalo, N.Y	67
Additional material supplied for the hearing record:	
Holloway, Edwin T., Associate Administrator for Finance and Investment, Small Business Administration:	
Chart, "Licensing Activity," for fiscal years 1974–81	18
Chart, "SBIC Leverage by Year of Licensing," leased from 1979–81	18
Memo, conflict-of-interest rules of 1958 act compared to rules of 1940 act	16
Kemp, Robert, president, Opportunity Funding Corp., and Fulcrum Venture Capital Corp.: Prepared statement	78
Koldyke, Martin, director, National Venture Capital Association, and general partner, Frontenac Co.: Prepared statement	87
Rider, Brent T., president, Union Venture Corp., Los Angeles, Calif., and chairman, NASBIC:	
Analysis, NASBIC comments on SBA's position on H.R. 5302	60
Article, "Who Creates Jobs," David L. Birch, Public Interest magazine, fall 1981	47
Comments, minor amendment to section 3, H.R. 5302 recommended by NASBIC	38
Prepared statement	41
Study, "Cost to the Federal Government To Increase Employment Through the Small Business Investment Company Program," Deloitte Haskins & Sells	34
Ross, Donald A., president, Rand Capital Corp., Buffalo, N.Y., and governor, NASBIC:	
Article, "High Technology Industry Sets Its Sites Downtown," Buffalo News, January 6, 1980	30
Article, "Nanodata Corp. Completes Purchase of Weed Building," Buffalo News, April 6, 1979	29
Article, "Nanodata Deal Is Catalyst for Area," Buffalo News, April 8, 1979	32
Prepared statement	21

H.R. 5302, SMALL BUSINESS VENTURE CAPITAL ACT OF 1981

WEDNESDAY, MARCH 24, 1982

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON TAX, ACCESS TO EQUITY CAPITAL AND BUSINESS OPPORTUNITIES, COMMITTEE ON SMALL BUSINESS,
Washington, D.C.

The subcommittee met, pursuant to notice, at 9:39 a.m., in room 2359 Rayburn House Office Building, Hon. Henry J. Nowak (chairman of the subcommittee) presiding.

OPENING STATEMENT OF CHAIRMAN NOWAK

Mr. NOWAK. The subcommittee will come to order. I welcome everybody here this morning. Today we will hear testimony on the Small Business Venture Capital Act, H.R. 5302. This legislation is designed to improve and strengthen the Small Business Investment Company program and the Small Business Administration.

[The bill H.R. 5302 follows:]

97TH CONGRESS
1ST SESSION

H. R. 5302

To amend the Small Business Investment Act of 1958 to improve the operations of small business investment companies.

IN THE HOUSE OF REPRESENTATIVES

DECEMBER 16, 1981

Mr. NOWAK (for himself and Mr. MARRIOTT) introduced the following bill; which was referred to the Committee on Small Business

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A BILL

To amend the Small Business Investment Act of 1958 to improve the operations of small business investment companies.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SHORT TITLE

SECTION 1. This Act may be cited as the "Small Business Venture Capital Act of 1981".

1 REPEAL OF $35,000,000 LIMITATION ON AMOUNT OF DE-
2 BENTURES ELIGIBLE FOR PURCHASE OR GUARANTEE
3 BY THE SMALL BUSINESS ADMINISTRATION

4 SEC. 2. Paragraphs (1) and (2) of section 303(b) of the
5 Small Business Investment Act of 1958 (relating to borrow-
6 ing power) are each amended by striking out "In no event
7 shall the debentures of any such company purchased or guar-
8 anteed and outstanding under this paragraph exceed
9 $35,000,000.".

10 CERTAIN AMOUNTS OF UNREALIZED APPRECIATION
11 TAKEN INTO ACCOUNT FOR LEVERAGE LIMITS

12 SEC. 3. Section 303 of the Small Business Investment
13 Act of 1958 (relating to borrowing power) is amended by
14 adding at the end thereof the following new subsection:

15 "(d)(1)(A) Except as provided in paragraph (3), for pur-
16 poses of determining the amount of debentures which may be
17 purchased or guaranteed and outstanding at any one time
18 from any company, the combined private paid-in capital and
19 paid-in surplus of such company shall be treated as including
20 an amount equal to the lesser of—

21 "(i) 50 percent of the amount of the net unreal-
22 ized appreciation on the marketable securities held by
23 such company, or

24 "(ii) $10,000,000.

25 "(B) For purposes of this subsection—

1 "(i) the term 'marketable securities' means any
2 security which is listed on a securities exchange which
3 is registered under the Securities Exchange Act of
4 1934 or which is quoted in the National Association of
5 Securities Dealers Automated Quotation System
6 (NASDAQ) and which is supported by at least three
7 registered broker-dealers who are currently maintain-
8 ing a market in said security.
9 "(ii) the term 'security'—
10 "(I) means a share of stock in a corporation,
11 but
12 "(II) does not include a bond, debenture,
13 note, or certificate, or other evidence of indebted-
14 ness, unless the Administrator determines that
15 such indebtedness be treated as stock by reason of
16 conversion or call rights, rights in earnings or
17 assets, priorities or preference as to distributions
18 of earnings or assets, or similar factors, and
19 "(iii) the determination of net unrealized apprecia-
20 tion of a marketable security shall be made as of the
21 date of the submission of the application to the Admin-
22 istration for the purchase or guarantee of the debenture
23 under this section.
24 "(2)(A) If, at any time—

1 "(i)(I) 70 percent of the amount of net unrealized
2 appreciation to which the 50-percent limitation was ap-
3 plied under paragraph (1)(A)(i) exceeds
4 "(II) the amount of the net unrealized apprecia-
5 tion on marketable securities held by any company at
6 such time, and
7 "(ii) there is outstanding at such time an amount
8 of debentures purchased or guaranteed by the Adminis-
9 tration which could not be so purchased or guaranteed
10 based on such appreciation at such time,
11 then such company shall be required to increase its combined
12 private paid-in capital and paid-in surplus by an amount
13 equal to such excess.
14 "(B) If any company required under subparagraph (A)
15 to increase its combined private paid-in capital and paid-in
16 surplus fails to carry out such increase within the time pre-
17 scribed by the Administrator, such company shall, to the
18 extent provided by regulations prescribed by the Administra-
19 tor, repay an amount of debentures purchased or guaranteed
20 by the Administration equal to—
21 "(i) the excess described in subparagraph (A),
22 multiplied by
23 "(ii) the percentage under paragraph (1) or (2) of
24 subsection (b) which applied to such company in com-

93-612 O—82——2

1 puting the amount of its debentures which were pur-
2 chased or guaranteed by the Administration.
3 "(3) Paragraph (1) shall not apply for purposes of deter-
4 mining under subsection (b)(2) whether a company has satis-
5 fied the requirement of section 302(a) regarding private paid-
6 in capital and paid-in surplus.".

7 ALLOWANCE OF DISCRETIONARY INVESTMENTS

8 SEC. 4. The last sentence of section 308(b) of the Small
9 Business Investment Act of 1958 is amended to read as fol-
10 lows: "Such companies may invest funds not reasonably
11 needed for their current operations in direct obligations of, or
12 obligations guaranteed as to principal and interest by, the
13 United States, maturing within one year, or in certificates of
14 deposit maturing within one year, issued by any institution
15 the accounts of which are insured by the Federal Deposit
16 Insurance Corporation or the Federal Savings and Loan In-
17 surance Corporation, or in savings accounts of such institu-
18 tions, or in repurchase agreements issued by national banks,
19 member banks of the Federal Reserve System and non-
20 member insured banks, maturing within one year, which re-
21 purchase agreements are secured by United States Govern-
22 ment securities, or in securities rated AA by Moody's Inves-
23 tors Service, Incorporated or AAA by Standard and Poor's
24 Corporation maturing within one year.".

1 COORDINATION OF CONFLICT OF INTEREST RULES FOR
2 SMALL BUSINESS INVESTMENT COMPANIES REGULAT-
3 ED BY THE INVESTMENT COMPANY ACT OF 1940

4 SEC. 5. Section 308 of the Small Business Investment
5 Act of 1958 (relating to miscellaneous) is amended by adding
6 at the end thereof the following new subsection:

7 "(j) Any small business investment company which is
8 subject to section 57 of the Investment Company Act of
9 1940 shall be exempt from regulations prescribed by the Ad-
10 ministrator under section 312 of the Small Business Invest-
11 ment Act of 1958, as amended.".

12 SMALL BUSINESS INVESTMENT COMPANIES AUTHORIZED
13 TO MAKE LOANS TO EMPLOYEES TO BUY OPTIONS IN
14 COMPANY STOCK

15 SEC. 6. Section 308 of the Small Business Investment
16 Act of 1958 (relating to miscellaneous) is amended by adding
17 at the end thereof the following new subsection:

18 "(j)(1) Any small business investment company may
19 make a loan to any employee of the company for any reason
20 connected with the employment of such employee by the
21 company for the purchase of any stock of such company.

22 "(2) Under regulations prescribed by the Administrator,
23 rules similar to the rules promulgated under section 57(j) of
24 the Investment Company Act of 1940 shall apply to loans
25 under this subsection.".

Mr. NOWAK. The bill which I introduced with Dan Marriott, our ranking minority member, on December 16, 1981, will encourage greater utilization of the SBIC program as an important source of funding of venture capital for the small business community. Specifically, it would remove unnecessary limitations on the amount of leverage available to any one SBIC, and will permit the SBIC's to include a restricted portion of the unrealized appreciation of their marketable securities for leveraging purposes.

In addition, among other things, the bill would also eliminate the overlapping of dual regulation of certain SBIC's which are subject to both the Investment Company Act of 1940 and the Small Business Investment Act of 1958.

Since 1958, when Congress recognized the need to develop an organized source of venture capital for the small firms, the SBIC program has displayed an exceptionally successful track record. For example, recent SBA statistics indicate that approximately 47,000 small companies have received over $4 billion in venture capital investment as well as invaluable management assistance since the establishment of the SBIC program.

A recent study also demonstrates the cost efficiency of the SBIC program. According to this study, the Government spent only $4 million on the SBIC program in 1979. This Federal outlay appears slight when measured against the fact that the SBIC's or portfolio companies and their employees paid over $440 million in Federal taxes in that same year.

The breakdown of these statistics indicates that the Government has received more than $110 in tax revenues for every dollar spent in this program. The Nation is presently experiencing a severe and protracted recession caused by, in large degree, high and volatile interest rates which has resulted in declining productivity, increased business bankruptcies and record-level unemployment.

These economic trends have made it increasingly important to examine and propose viable mechanisms to assist small business persons in meeting their capital formation needs. I believe that this program will improve the scope and effectiveness of the SBIC program.

In particular, this measure will provide an important incentive for spurring growth and expansion of small businesses in the creation of new jobs.

At this time, I want to introduce to you the ranking minority member who has worked with us very closely and has taken a leadership position in this legislation, Dan Marriott.

OPENING STATEMENT OF HON. DAN MARRIOTT, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF UTAH

Mr. MARRIOTT. Thank you, Mr. Chairman. I have no prepared speeches to give today, but I would like to say that I think we are heading in the right direction on these SBIC's, and I certainly want

to thank you for the leadership role that you've played in getting the funding out because, as you know the Reagan administration tried to get the funding of SBIC's down to about $125 million. The chairman and others were successful in keeping that up to the $250 level, and I think that is certainly a step in the right direction.

It's my personal opinion that these partnership arrangements are the key to the future of small business participation in the private sector. I think we are going to get away from direct loans and indirect loans and guaranteed loans and all the rest eventually; and, the program of the future will be partnership arrangements such as we see now in SBIC's.

So I look forward to hearing the testimony of the witnesses today to discuss how the program can be made better and how we can utilize this program to vitalize the private sector. Mr. Chairman, I appreciate you holding these hearings.

Mr. NOWAK. Thank you very much. I want to express my appreciation for your involvement in this, and I know that some of the incentives that we've put together are controversial. However, I think there are some important parts that could be made available and help move this economy forward.

Let us bring our first witnesses here from the Small Business Administration. We have with us Edwin Holloway who is appointed Associate Administrator for Finance and Investment effective February 1982. Prior to that, he was Acting Associate Administrator within the same office.

Also accompanying him will be Robert Lineberry, who is Deputy Associate Administrator of the Investment Division, and John L. Werner, who is Director of Program Policy and Evaluation Staff.

Gentlemen, your testimony will be incorporated in toto into the record, and you may proceed as you so desire.

TESTIMONY OF EDWIN T. HOLLOWAY, ASSOCIATE ADMINISTRATOR FOR FINANCE AND INVESTMENT, SMALL BUSINESS ADMINISTRATION, ACCOMPANIED BY ROBERT LINEBERRY, ACTING DEPUTY ASSOCIATE ADMINISTRATOR FOR INVESTMENT DIVISION, AND JOHN L. WERNER, DIRECTOR OF PROGRAM POLICY EVALUATION STAFF

Mr. HOLLOWAY. Thank you, Mr. Chairman. I am pleased to have the opportunity today to appear before you to discuss the administration's views on H.R. 5302, the Small Business Venture Capital Act of 1981, which you have introduced along with Congressman Marriott.

Accompanying me today are Robert G. Lineberry, Acting Deputy Associate Administrator for Investment and John Werner, Director of the Program Policy Evaluation Staff in the Investment Division.

Let me begin by stating that although SBA is concerned about the policy implications of H.R. 5302 upon the Small Business Investment Company program, it fully recognizes the assistance that SBIC's provide to many of the Nation's small businesses.

Created by Congress in the Small Business Investment Act of 1958 to fill a gap in the availability of long term and equity financing to small business, SBIC's have to date provided more than $4 billion of financing to over 47,000 small concerns. Some of these

small concerns such as Federal Express, Memorex, and Teledyne, have become large successes.

Presently, the SBIC industry is, for the most part, positioned at the lower dollar volume end of the venture capital industry. The latter includes some very well financed venture capitalists who, without Government participation, make sizable investments in young growth firms. SBA sees a continuing need to respond to venture capital requirements on a smaller scale, thus bridging the gap for small but promising businesses that are not yet candidates for the larger private venture capitalists or the public financial markets.

Section 2 of this bill would amend paragraphs 1 and 2 of section 303(b) of the Small Business Investment Act of 1959 to provide the repeal of the present $35 million limitation on the par value of debentures eligible for purchase or guarantee by the Small Business Administration. Present law sets a ceiling of $35 million upon the total amount of debentures purchased or guaranteed and outstanding at any one time for a given small business investment company. This proposed legislation would repeal that ceiling and put no other ceiling in its place.

SBA opposes this provision for several reasons. First, we question the need for such an amendment. At the present time, only one SBIC is likely to utilize this authority. Second, an unlimited amount of capitalization eligible for leverage by SBA would contribute to the establishment of larger SBIC's. This could lead to the utilization of all of SBA's budgeted funds by a relatively small number of small business investment companies.

This is not a desirable result. Further, such immense SBIC's would, in all likelihood, concentrate on providing larger financings to larger small businesses. While this is not specifically prohibited by the Small Business Investment Act, SBA views it as desirable that there be a relatively large number of small business investment companies geographically spaced throughout the Nation in order to serve the needs of the entire small business community.

Concentration of our funding in a small number of large SBIC's would not contribute to that goal. Further, SBA does not feel that it is desirable from a credit prospective to have our portfolio concentrated in a few large SBIC's. Our diversification needs are at least equal to any other prudent portfolio manager in this respect.

Section 3 of the bill would add a new subsection to section 303 of the Small Business Investment Act which would provide that an SBIC's combined private paid-in capital and paid-in surplus should be treated as including an amount equal to the lesser of 50 percent of net unrealized appreciation on marketable securities held by such a company or $10 million.

SBA does not favor enactment of this proposal. The effect of the proposal is to increase the base upon which the statutory leverage factor is applied for the purpose of determining the amount of leverage available from SBA to a small business investment company by adding in the paid-in capital and paid-in surplus an amount of unrealized appreciation on marketable securities.

Although we see some desirable effects from such a proposal, we feel these effects are outweighed by other considerations. We object

to the provision first because it would greatly increase SBA's risk as a creditor of any SBIC which would take advantage of it.

This is due primarily to the fact that there would be no assurance an SBIC whose paid-in capital and surplus were increased by this mechanism would be able to cope with depreciation in marketable securities and repay SBA for leverage which had been extended for appreciation if the appreciation ceased to exist. In the alternative, there is also no assurance such an SBIC would be able to raise additional capital to make up for depreciation.

In addition, the proposal does not provide for comparable recognition of an offset for unrealized depreciation of unmarketable securities in which many SBIC's have considerable portions of their investment portfolios. The provision would therefore lead to the unrealistic leveraging of undercapitalized SBIC's.

Further, SBA fears that this provision would promote the stagnation of investment by SBIC's in small businesses which have provided a large degree of capital appreciation as a means to insure increased leveraging for the SBIC. It is our view that it is desirable for SBIC's to pursue an investment pattern of fairly regular investment in a number of small businesses rather than promoting a pattern of concentrated and stagnant investment in a few winners.

We fear that this provision if enacted would have the latter effect. Finally, we fear that this provision would promote investment in publicly held businesses by SBIC's rather than in small nonpublicly financed companies. We feel that the latter are deserving of, and statutorily intended to receive a fair share of SBIC investment.

Section 4 of the bill would amend section 308(b) of the Small Business Investment Act by providing that SBIC's would be able to invest funds not reasonably needed for current operations in enumerated investment vehicles. This provision would, if enacted, allow SBIC's to place idle funds in these specified investment vehicles for the purpose of obtaining a return on those funds prior to the time that they would be invested in small businesses.

As such, SBA certainly does not oppose enactment of the provision subject to certain adjustments. First, we feel that investments and certificates of deposit should be limited to Federal insurance maximums. Second, we feel repurchase agreements should only be secured by direct obligations of the Treasury. However, we wish to emphasize that we do not encourage the accumulation of idle funds for the purpose of making such investments.

Section 5 of the bill would add a new subsection to section 308 of the Small Business Investment Act. This subsection provides that any SBIC which is subject to the provisions of section 57 of the Investment Company Act of 1940, the 1940 act, would be exempt from the conflict of interest regulations SBA promulgates pursuant to section 312 of the Small Business Investment Act. SBA must oppose this provision.

Section 57 of the 1940 act generally prohibits the principals of certain investment companies known as business development companies, BDC's, from engaging in the purchase for, or sale of the securities to, their BDC or a company controlled by it. These prohibitions are intended to avoid certain types of self-dealing by busi-

ness development companies principals to the detriment of investors in the BDC.

It should be noted that under the 1940 act, BDC's may be SBIC's. Section 312 of the Small Business Investment Act permits SBA to promulgate regulations to prohibit certain types of self-dealing by SBIC's between themselves and the small businesses to which they make financings.

We oppose the proposed legislation even though arguably the proposal would only apply to SBIC's which are covered by the 1940 act provision, because the relevant provisions of the 1940 act have a different purpose than do those of the Small Business Investment Act and are enforced from a different perspective. We fear that the protections which our regulations are intended to provide to small business borrowers and SBA will be lost if we depend only on enforcement of the 1940 act.

In addition, it must be kept in mind that SBA is a creditor of the SBIC's it regulates. In this regard, we must have the ability to prohibit conflicts of interest between the principals of SBIC's and portfolio concerns as well as between the SBIC's and their principals in order to protect our creditor position.

Under this proposed legislation, SBA's ability to prohibit conflict of interest situations involving a given SBIC could be compromised, because the proposed legislation would deprive SBA of control over conflict of interest situations in which the SBIC was a BDC. This would be so even though SBA has a statutory interest in regulating such an SBIC.

Finally, certain provisions of section 57 of the 1940 act are in conflict with SBA's present regulations. For example, subsection 57(g) of the 1940 act permits sales or leases in the ordinary course of business between insiders and BDC's and their portfolio concerns. Our regulations generally prohibit this type of transaction, and those few transactions of this nature which are permitted are closely regulated.

Section 6 of the bill would amend section 308 of the Small Business Act by adding a new subsection which would permit small business investment companies to make loans to employees for any reason connected with employment for the purchase of stock in the small business investment companies. SBA does not favor this provision for several reasons. We understand the intent of the provision is to provide an incentive to employees of small business investment companies to perform in a productive manner. We anticipate that the purpose of the provision could be fulfilled by the utilization of standard stock option plans or other similar vehicles which are presently available to small business investment companies, and therefore the proposed legislation is not necessary to accomplish the intended purpose.

Furthermore, in our view this provision would divert funds properly available for investment in small businesses to employees of SBIC's for the purchase of SBIC stock. While we recognize the importance of management by incentives, we would prefer that funds made available to SBIC's by virtue of SBA leverage for the purpose of investment in small businesses be utilized for that purpose, rather than for the provision of incentives to their employees.

In addition, we fear that this provision would be difficult to administer and that regulations adequately administering the provision would be exceedingly complex.

Mr. Chairman, this concludes my prepared statement, and I would be pleased to answer any questions you may have.

Mr. NOWAK. Thank you very much for your unequivocal support of all the provisions of the bill. Let me go through a couple of the specifics here. The first two provisions dealing with the increased leveraging potential of individual SBIC's really do not require the SBA to provide more leveraging for all the requests that are made.

We're still maintaining that the SBA has the authority through the appropriation process and through your own control over who receives funds or who expands. Doesn't that still give you the ability to control the problem that you spoke of in your testimony?

Mr. HOLLOWAY. Mr. Chairman, I think we do have some other abilities to control the problem alluded to, and I think that our opposition is generally bottomed on our concept of the proper positioning of the SBIC program in the total venture capital industry.

Mr. NOWAK. Let me ask you a question: You mentioned also regarding this problem of geographical distribution. Do you feel you have a sufficient coverage now in this country with the SBIC's, geographically speaking, that there are abilities in most major centers?

Mr. HOLLOWAY. It is not our view that the market is saturated at this point. There are a number of places in the country where we believe there is still a need for the type of venture companies that the SBIC's are to meet the venture capital needs of small business.

Mr. NOWAK. The point I'm trying to make is, if there are those gaps, and you have a very aggressive, very successful SBIC and well-administered program, and they wanted to expand in those areas, even though they may be located and concentrated in New York City or Philadelphia and they find opportunities elsewhere where there aren't SBIC's, what would be the objection of letting them go into those areas with an expanded leverage base and provide the bottom line of capital for some venture?

Mr. HOLLOWAY. Congressman, I believe my views would be tempered if I felt that would be the result of a large number of large SBIC's.

We tend to see it on balance as a move toward very large SBIC's, highly capitalized and highly leveraged that in turn would be going into very large deals and deals where the need is most likely to be met by the private sector without Government intervention.

Mr. NOWAK. We still come back to the point that you would still have control over who would get that year's appropriations, so if you felt that one was eating up the industry, so to speak, you still retain the inhouse power to control that kind of situation. Isn't that true?

Mr. HOLLOWAY. Yes, sir, that is, and I accept your statement of that as a valid perspective on this issue.

Mr. NOWAK. Let me turn to another problem that we've given that as much as $153 million, I believe is the figure, of guaranteed loans could be rolled over for fiscal 1983. We were looking, as Mr. Marriott said, at a very low figure from the administration regard-

93-612 O—82——3

ing this program. I think the proposal was something like $125 million.

I wonder if you could explain for the record how that rollover would have been put into effect, and what your experience has been in the past as far as the paying off that $153 million in percentage so we can get some perspective as to what the impact would have been on new capital?

Mr. HOLLOWAY. Mr. Chairman, the $153 million figure is lessened right away by some $35 million debentures maturing for SBIC's that are in liquidation. So certainly we would not be rolling over the debentures of those SBIC's that are in liquidation.

In addition, we currently have a survey in progress going to the SBIC's themselves asking for feedback on what their intentions are. Many companies, SBIC's included, do borrow money and sell debentures with the idea that when they come due, they will be paid. We believe some of these debentures will be paid.

Probably, our best estimate is in the neighborhood of $90 to $100 million of the available funding at the $125 million level would have accommodated the rollovers that would have been appropriate, and that we would have had in the nature of $25 to $30 million for new money going into the new SBIC program.

Mr. NOWAK. I'll try to make that clear, that you are talking $25 million or so for all the SBIC's that are out there, plus all the new SBIC's that may come into existence.

Mr. HOLLOWAY. Yes, sir.

Mr. NOWAK. Or that would put together a program. If you just divided that $25 million up by the 350 or so SBIC's that are out there, you would come down to a very, very low figure—in fact, really no expansion in fiscal 1983 if you consider that rollover would be in the area of what it traditionally has been.

Mr. HOLLOWAY. There is a lot of potential eligibility for leverage out there. It's interesting to note that even in the past 4 or 5 years, every year the SBIC industry has not drawn down all of the budget authority that has been available for a variety of reasons.

Some of our larger SBIC's, for example, rather than seeking 3 to 1, 4 to 1 or an expanded figure based on leveraging the unrealized depreciation in the marketable securities, really have outstanding leveraging in the area of 1 to 1 and 2 to 1 because of the inherent problems of debt servicing when you're making venture capital investments. So they don't all use the maximum leveraging of the capitalization, and very few of the large ones do.

Mr. NOWAK. Yes. What we're trying to do here is find a way to make some venture capital available. Mr. Marriott, I think, is correct when he said we're looking at one specific program here, but when you tier the whole Federal structure of guaranteed loans, EDA, and LDC's, and others you've got a very small amount of that money, in looking for capital investment.

This program certainly has proven to be one where you have some individual interests. A very important element is management systems where in all the other Federal programs that I know of, you have very little control or very little involvement with the loans, and those programs, the overt programs—if we can label them as such—are going by the board. So we want to make sure

that at least we have some mechanism to fill in all of these gaps when that is withdrawn.

We think this is probably the best possible way to make dollars available, and I hope that on some of these provisions—and you did allude to a couple in your testimony—there may be with some changes, we could find the reason to support or at least package a couple of the more important incentives. This will keep it alive to the extent there is requisite demand although we don't mandate it.

I've tried to stay away from pushing the program without a market out there. I want to continue giving the SBA total control over both in terms of size and leveraging and who you give the dollars to. This way you don't lose control over your portfolio, which I can well understand is a concern.

Let me ask you this: the unrealized appreciation section that we have in there, I understand that SBA has at least conceptually looked at something like this in the past and has, in fact, tentatively drawn up some drafts of tentative regulation on this. Is this true?

Mr. HOLLOWAY. Let me ask Mr. Werner if he will respond to that question.

Mr. WERNER. Yes, Mr. Chairman. There are presently proposed regulations in the hands of the Office of Management and Budget for their clearance which propose to make a portion of appreciation marketable, documented, unrealized appreciation available, but restricted only for the purpose of using it for establishing a base for computing the overline or the maximum investment that could be made to one small business via an SBIC. That's the only context that I can think of short of going back 4 or 5 years ago when there was a proposal for using a debenture as the vehicle for participation by SBA in the unrealized appreciation.

Mr. NOWAK. Well, I hope you'll keep this subcommittee advised of that proposed reg, and we can follow that through and perhaps combine it with some of the others to make some sense out of what we are both trying to accomplish. You have some constraints because of OMB and we realize that; and we do, too, in looking at the total budget prospects for 1983.

By the same token—and I hope you will emphasize this also to OMB—that there are other programs that we're helping out, but which have been severely limited or eliminated totally. If we're going to have any program structure, this seems to be a viable one that has worked in the past; with great input, I think, from the managers of these SBIC's.

Let me go onto a question regarding the 1940's act exemption, and the conflict-of-interest rules that you've set up. In many areas, it looks like the 1940 act really does provide even more stringent rules in many areas. I'm wondering if you have specific problems with anything that's left out of the 1940's act other than the one you've alluded to in the testimony, and if we could get more specific, maybe we could work around that.

Mr. HOLLOWAY. Mr. Chairman, with respect to that particular provision, our problem mainly is that we have a problem in coming up here to this committee and defending conflict-of-interest transactions in any form, and really don't believe that the long-term best interests of the SBIC program are served by SBA not having

control under its own regulations of these conflict-of-interest transactions.

It is out of that thought that we oppose this particular provision. The SEC itself is really more concerned with the protection of the investors in companies whereas SBA's prospective is interest in the small business concern, as well as interest in our own position as a creditor.

We believe that the conflict-of-interest transactions are in all of our programs at SBA the very hardest for us to come up here and defend and believe that we're not doing the right thing if we don't hold a taut line on this conflict-of-interest business.

Mr. NOWAK. All right, what I would like to do is to hold the record open so that we could get some specific examples as to why the conflict-of-interest rules of the Small Business Investment SBIC Act of 1958 would be preferable to those that are contained in the 1940's act.

Mr. HOLLOWAY. We'd be pleased to submit you a paper on that for the record.

Mr. NOWAK. I think it would give us some deeper understanding of what problems you've faced over the years in this program.

[The information referred to above follows:]

To: Marshall Parker, Associate Administrator/External Affairs
From: Robert S. Webber, Acting General Counsel
Re: H.R. 5302, Small Business Venture Capital Act of 1981

On March 24, 1982, at 9:30 a.m., the Subcommittee on Tax, Access to Equity Capital and Business Opportunities held a hearing on H.R. 5302, the Small Business Venture Capital Act of 1981. During Mr. Edwin T. Holloway's testimony, Congressman Henry J. Nowak, who introduced the bill with Congressman Dan Marriott, requested that SBA submit for the record some specific examples of conflicts of interest which are not covered by section 57 of the 1940 Investment Company Act, but which are prescribed by SBA regulation, 13 C.F.R. § 107.1004.

In conjunction with the Office of Finance of the Office of General Counsel, the General Counsel's Office of Legislation has prepared the following, which I regard as suitable for submission to the Congressional Record.

I. SUMMARY

Section 5 of H.R. 5302, 97th Congress, 1st Session would amend section 308 of the Small Business Investment Act by adding a new subsection (j) that would read as follows:

"Any small business investment company which is subject to section 57 or the Investment Company Act of 1940 shall be exempt from regulations prescribed by the Administrator under section 312 of the Small Business Investment Act of 1958, as amended."

The Small Business Administration opposes the enactment of section 5 because its effect goes well beyond its stated purpose. That purpose purports to avoid dual regulation by SBA and the SEC of transactions which otherwise would require prior approval from both agencies. Instead of having a limited effect on those transactions, the proposed legislation would confer upon small business investment companies (SBIC's) that are also business development companies (SBIC/BDC's) "carte blanche" with respect to any kind of self-deal other than one falling within the limited classes described in section 57 of the Investment Company Act of 1940.

An ordinary BDC and an SBIC/BDC differ fundamentally. While SBA is never a creditor of an ordinary BDC, it is generally a creditor of an SBIC. SBA's conflict of interest regulation is intended, inter alia, to protect that creditor interest against deals that may be prejudicial to the interests of the SBIC itself, but highly beneficial to the SBIC's stockholders. SBA's self-dealing regulation assumes that where a self-deal is involved the credit judgment of the SBIC is compromised even when the SBIC enters the deal in good faith. In addition, SBA has a duty to protect the portfolio concerns of an SBIC against transactions prejudicial to their interest, even if such transactions are advantageous to the SBIC. None of the foregoing are regulat-

ed by section 57 nor are they concerns of the SEC, which regulates to protect investors.

II. COMPARISON OF 13 C.F.R. § 107.1004 AND § 57 OF THE INVESTMENT COMPANY ACT OF 1940

Before making a point-by-point comparison of SBA's conflict of interest regulation with section 57, it is necessary to compare SBA's definition of "Associate of a Licensee" with its 1940 Act counterpart, "affiliated person" (section 2(a)(3)). Section 107.3 of SBA's regulations defines "Associate of a Licensee" quite broadly. The definition predictably covers the officers, directors, investment advisers and owners of 10 percent or more of the SBIC's capital. It also includes persons who control, are controlled by, or are under common control with, the SBIC, and close relatives of the previously described associates. Finally, the definition covers any small concern in which an associate of an SBIC is an officer, director, or owner of an equity interest in 10 percent or more, whether or not that small concern is controlled by SBIC or its associate. The definition of "affiliated person" as set forth in section 2(a)(3) of the 1940 Act is narrower: it does not reach either the close relatives of an affiliated person or concerns which are not controlled by such affiliated persons.

Subsection 107.1004(a) sets forth a general prohibition against "[s]elf-dealing to the prejudice of the Small Concern, or of a Corporate Licensee or its shareholders, or in the case of an Unincorporated Licensee, the partnership or its members, or of SBA." Section 57 contains no such general prohibition: it covers only limited classes of transactions.

Subsection 107.1004(b)(1) proscribes direct or indirect licensee financing of any of its associates. Section 57 does not regulate all such transactions. For example, under section 57 alone an SBIC/BDC might be permitted to lend money to the brother of its president, since the SEC does not consider a personal relationship sufficient in itself to create an affiliate relationship.

Subsection 107.1004(b)(2) regulates cross-dealing: financing pursuant to an agreement under which SBIC No. 1 agrees to finance the associates of SBIC No. 2 in exchange for No. 2's financing of No. 1's associates. Section 57 does not regulate such agreements.

Subsection 107.1004(b)(3) prohibits borrowing money from portfolio concerns by a Licensee or its associate. Section 57 covers only borrowings from concerns controlled by the BDC.

Subsection 107.1004(b)(4) generally regulates financing that are intended to repay a debt owed to an associate. Section 57 does not clearly cover such financings.

Subsection 107.1004(b)(5) generally regulates a Licensee's financing of the purchase of property from any associate of the Licensee. Section 57 applies to this type of transaction only if the portfolio concern is controlled by the SBIC/BDC.

Although subsection 107.1004(c) speaks of "joint financings," it also covers financings by a Licensee and its associates that are more or less contemporaneous. The intent of the provision is to regulate the apportionment of risk and profit between the Licensee and its associate. Section 57 covers only some of these transactions. It addresses only financings made on a joint and several basis involving an "associate" (to use SBA's term) and the SBIC/BDC.

Subsection 107.1004(d) is an anti-kickback regulation that has no counterpart in section 57.

Subsections 107.1004 (e), (f), and (g) are procedural regulations. It is SBA's opinion that subsection 107.1004(g) effectively relieves 1940 Act companies from the burden of dual regulation by SBA and the SEC without sacrificing SBA's interest. Subsection 107.1004(g) accepts, after notice and hearing, an SEC determination that a given transaction is exempt under the SEC conflict of interest rules, whereas section 57 exempts certain transactions without requiring the SEC's action. Moreover, no determinations of fairness are required for such exempted transactions under section 57.

Mr. NOWAK. I've taken a lot longer than I've intended to. Let Mr. Marriott who has been working on this legislation have some time right now.

Mr. MARRIOTT. I just have one two-part question, Mr. Holloway, if you will. One of your concerns about lifting the ceiling is, as I understand, that you're afraid that the existing SBIC's might squeeze out the new SBIC's coming on, that they'll take up money that might go to new SBIC's.

How many new applications for new SBIC's do you have in the course of a year?

Mr. HOLLOWAY. Mr. Congressman, may I call upon Mr. Lineberry or Mr. Werner to respond to that? Do you know, Bob?

Mr. LINEBERRY. We are currently running—and this will vary from year to year—but we are currently running something in the neighborhood of 50 to 75 new applications a year. Now, that's in terms of applications that actually get processed, not counting informals or preliminaries.

Mr. MARRIOTT. How many of those are approved for a license?

Mr. LINEBERRY. I would have to submit that for the record.

[The information referred to above follows:]

LICENSING ACTIVITY

[Dollars in millions]

Fiscal year	SBIC's		MESBIC's		Combined	
	Number	Private capital	Number	Private capital	Number	Private capital
1974	16	$16.6	6	$2.3	22	$18.9
1975	13	8.6	16	7.5	29	16.1
1976	15	7.8	8	5.8	23	13.6
1977	27	22.3	9	4.1	36	26.4
1978	37	29.5	19	12.4	56	41.9
1979	45	66.6	31	13.8	76	80.4
1980	37	49.6	23	12.2	60	61.8
1981	44	59.0	21	13.2	65	72.2

Mr. WERNER. As of the end of the fiscal year, 44 SBIC's were licensed in 1981 and 21 301(d) SBIC's, so called MESBIC's, a total of 65.

Mr. MARRIOTT. Twenty-one MESBIC's?

Mr. WERNER. And 44 SBIC's, so-called regular SBIC's.

Mr. MARRIOTT. And do you have the information as to how much capital was required to satisfy them for the year?

Mr. WERNER. No, I can't tell you the leverage. We'll have to submit that for the record. I couldn't tell you now, of that new entry capital, how much it's been leveraged since then.

[The information referred to above follows:]

SBIC LEVERAGE BY YEAR OF LICENSING AS OF DEC. 31,1981

[Dollars in millions]

Year licensed	SBIC's	Private capital	Leveraged	Leverage
1979	33	$55.1	19	$46.3
1980	43	80.7	14	15.6
1981	32	41.1	0	0

Source: Operating directory of SBIC's, U.S. Small Business Administration, Dec. 31, 1981.

Mr. MARRIOTT. OK, but does the figure appear to you to be a figure that would be in direct conflict with increasing the ceiling on the existing SBIC's?

Mr. WERNER. I'm sorry, I didn't quite——

Mr. MARRIOTT. Does the amount of money needed to address the needs of the new SBIC's run in conflict with increasing the ceiling for existing SBIC's?

Mr. WERNER. Well, in effect, it's not in conflict, but it's a matter of unfunded eligibility, and no matter where that comes from, it either comes from established SBIC's as they are today or new SBIC's that are licensed. Now, it's analogous to just more people with greater eligibility wanting a slice of the pie.

Mr. MARRIOTT. What is the demand out there for new SBIC's and is it reasonable to think that if the ceiling was raised to above $35 million or even unlimited, that that would pose any undue restraints on new SBIC's coming in the market?

What I'm trying to get at is the demand level versus the amount of capital available, and whether or not there really is any conflict. Let's use the $250 million level for this. Suppose that passes the House. Now, with that amount of money, would that pose any problems in the next couple of years to the anticipated new SBIC's, given the fact that some existing SBIC's might want to increase their leverage?

Mr. WERNER. That depends on two things. First of all, we have witnessed a formation of a lot of SBIC's in the last 2 or 3 years, and I tend to want to believe—and this is not documented analysis, but I tend to want to believe—much of the capital gains tax reduction of 1978 unlocked quite a bit of capital in this country. That unlocking effect, of course, went all through the economy: the futures market, the collectibles and in the SBIC's, and in many other areas. The unlocking of that capital, of course, was a positive thing with respect to our program. It put in the hands of—potentially the hands of small business—a lot of capital.

I think that from the standpoint of prospectively, the future, of course, is uncertain for all of us, and I think the present state of the economy has a lot to say about what will happen.

SBIC's are like other financial institutions; in the near term, they're going to be asset managing, and they're going to be watching what they already have, as opposed to sticking their necks out too much further in any new transactions which, of course, is very prudent, and which we would encourage in some respects.

The other side of it is that the demand from small businesses for financing has run at a consistent $25 to $30 million a month from SBIC's, and we feel that part of that, about half of that, is supporting the portfolio companies they already have. Of course, whether or not the $250 million will be adequate if that is the ultimate number is sheer speculation to say whether it's adequate or not.

Mr. MARRIOTT. I have studied these SBIC's over the past several months and talked to a number of people, including those who are managing SBIC's. It seems to me that you don't just run out and start an SBIC. It takes skill, it takes intelligence, and it takes a lot of effort to get into the SBIC business to begin with.

So my concern is whether or not, even if you kept the ceiling, you'd really have that many new SBIC's coming on line, No. 1; and No. 2, it seems to me as I understand what the SBIC people are telling me, they are very selective in making loans and investments. They are not just passing money out up and down the

street; and, there are probably 10 or 20 or 100 people who would like to have money for every one they loan to.

Would lifting the ceiling allow the SBIC's to be a little bit more liberal in their policy and, thus, in the long run help small businesses more?

Mr. WERNER. The fear that we have is the opposite effect will occur. We feel that that selective filtering is a good thing, and that that's the marketplace working. Consequently, we feel that if the Government contributes more and more and becomes a bigger, and bigger participant in this process by leveraging SBIC's, that that selectivity might be hurt.

If that selectivity is hurt, then the market will be tampered with even more, and it could work the other way.

Mr. MARRIOTT. OK; I'm not sure I agree with that, but I appreciate your position. You say there is only one SBIC now that is approaching $35 million?

Mr. HOLLOWAY. There is only one SBIC, Congressman, that we feel is likely to use greater leverage than $35 million at the present time, and that there are only some 16 SBIC's that are funded up around the $8 or $9 million private capital figure, and 15 of those 16 are nowhere near their maximum leverage that they could draw down presently.

Mr. MARRIOTT. Thank you very much, Mr. Chairman.

Mr. NOWAK. Thank you very much. Let me again urge that you go back to the SBA and look at this program in relation to the total universe out there. Hopefully, you can make the case for the increased funding that we recommended. I think that it is necessary to at least have something out there as we anticipate the supply side economics to start picking up the economy.

We're going to be in a very precarious position if we don't have the available dollars being invested. I think this program is one where again, nothing is mandated. We are trying to provide for the contingencies and give you the tools so that you can service these SBIC's, given your total control over the programs and geographic areas. But if there is an exception, and I understand there are a couple that are up very close to $35 million, I don't know if there would not be others who could generate more capital if they saw the program in that kind of a scope, such as being able to go nationwide and perhaps open offices geographically where none exist today.

We are trying to give you the broad tools to work with without taking the specifics away from you or without mandating anything. Certainly, you know, this is fine and we could go through all of these points. But every one of these five points were passed and we didn't get the budget authority raised. This would be a meaningless exercise anyway.

What we're trying to do is give you some flexibility and then get you the proper budget authority so that the program can fully contribute to the recovery. I think there is going to be a great demand once this supply-side economics catches up. The other down side, of course, is that interest rate problem, and I fear this may be the only alternative for a long period of time because we are not going to solve this budget program and it's not going to be balanced to-

morrow even if everybody would agree in what direction they want to go.

But hopefully, we'd like to stay in contact with you and work with you on some of these specifics and see where you think it would be of some help to the program as we go along, considering the increase in the budget authority.

Mr. HOLLOWAY. Mr. Chairman, I would appreciate the opportunity to work with your staff on these matters, and I can assure you that I feel—and I should say here for the record—that in view of our opposition to some of these policy proposals here today, I don't want to be interpreted as not believing in this program.

This program we believe to be conceptually valid. We believe that it is one that we are willing to go to bat for with the OMB and advocate for where we believe proposals are in the long-term best interests of the program and workable and administrable by us. I would be pleased to work with your subcommittee.

Mr. NOWAK. Fine. Thank you very much, and I'm sure you will be interested in the rest of the testimony of people who are out there in the industry and working with the programs and in seeing what they have to say as they anticipate the new fiscal year.

Thank you very much.

Mr. HOLLOWAY. Thank you.

Mr. NOWAK. I'd like next to have the panel, if we may, of the National Association of Small Business Investment Companies and Donald Ross from Rand Capital Corp. to come forward. We'll get the testimony together, and then I think we could ask many of the same questions.

So, gentlemen, if you'll come forward? Brent T. Rider is the president of Union Venture Corp. of Los Angeles, Calif. He's a licensed SBIC with privately held assets of $20 million. Mr. Rider is also chairman of NASBIC, a trade association which represents the majority of all SBIC's and MESBIC's. He's accompanied by Walter Stults, who is the president of NASBIC.

For Rand Capital, we have Donald Ross who is the cofounder of Rand Capital Corp. and president since its beginnings in 1969. Prior to that, he was an officer with the Marine Midland Bank in Buffalo and has a distinguished record in community service; presently he is a trustee of the University of Buffalo Foundation.

Gentlemen, welcome and once again, I will just state your testimony will be incorporated into the record and you may proceed.

[Mr. Ross' prepared statement and attachment follows:]

PREPARED STATEMENT OF DONALD A. ROSS, PRESIDENT, RAND CAPITAL CORP., BUFFALO, N.Y., AND GOVERNOR, NASBIC

Mr. Chairman and members of the committee, thank you and Congressman Marriott for inviting me to testify today on the "Small Business Venture Capital Act of 1981" (H.R. 5302).

I am Donald A. Ross, President of Rand Capital Corporation of Buffalo, New York, a publicly held, closed-end venture capital company, with an SBIC subsidiary. On December 31, 1981, our assets totalled $8,067,140. I am also a Governor of the National Association of Small Business Investment Companies, a trade association which represents the overwhelming majority of all small business investment companies (SBICs) and Minority Enterprises Investment Companies (MESBICs).

As you know, SBICs are privately organized, privately capitalized and privately managed venture capital firms which provide equity capital, long-term loans and management assistance to new and growing small business concerns. SBICs are li-

censed under the Small Business Investment Act of 1958 and regulated by the Small Business Administration.

I appear before you today to strongly support H.R. 5302, and as President and CEO of an SBIC which has contributed to business and job development in Buffalo, New York. I'd like to explain my support in proper context.

RECORD OF THE SBIC INDUSTRY

Growth and investment levels.—Since 1959 when the Small Business Investment Company program was developed, SBICs have provided over $4 billion in venture capital to approximately 60,000 small business concerns. On December 31, 1981, there were 362 active SBICs with assets of more than $1.5 billion, almost equally divided between private capital and SBA provided loans (or leverage).

These numbers are rather impressive for a relatively young industry, but more important is the fact that the industry is growing and investing more dollars today than ever before. During 1981, SBICs invested $333 million—an increase of 12 percent from 1980, the busiest previous year. In January 1982, SBICs invested $45 million, an all-time monthly record—more than 60 percent above the January 1981 level.

Despite the current bleak state of the economy, hundreds of SBICs and thousands of entrepreneurs are bullish on the long-term future. Both the suppliers of venture capital and the entrepreneurs who utilize it continue to be optimistic on the ability of innovative, well-managed small firms to grow and be profitable.

It is noteworthy to mention that more SBICs with increased levels of private capital have been licensed during the past three years. Also, there is more private capital in the program now than ever before—almost $750 million, and that is twice as much as the industry had six years ago.

Economic impact of SBICs.—Two years ago NASBIC commissioned a study of the economic impact of SBIC financing on small businesses. The study was conducted by the accounting firm of Deloitte, Haskins & Sells and the economic consulting firm of Arthur D. Little, Inc. In summary, the study demonstrated that portfolio companies in which SBICs invested grew about ten times as fast as average small businesses in terms of profits, sales, employment growth, and tax payments.

Cost-benefit to the Government.—Last year, Deloitte, Haskins & Sells followed up the 1980 study with two others. The first one computed the direct costs and the direct benefits of the SBIC program to the Federal Government. Deloitte, Haskins & Sells found that the Federal Government spent $4 million on the SBIC program in 1979; half was the cost of administering the program; the other $2 million was SBA's losses on its loans to SBICs. In return for that $4 million, however, the Federal Government received a total of $440 million from increased taxes paid by SBICs, their portfolio companies, and their employees. Clearly, a 110 to 1 benefit-cost ratio represents an attractive investment for the Federal Government.

Job creation.—Professor David L. Birch of MIT has found that two-thirds of all new jobs between 1969 and 1976 were created by firms with 20 or fewer employees; and 80 percent of all such jobs were created by firms less than four years old.

In addition, SBA has compiled data on SBIC-assisted firms in 1981 and found that 67 percent of SBIC dollars went to firms four years old or younger and 64 percent of the firms assisted had fewer than 20 employees. It's evident that SBIC dollars are going overwhelmingly to those firms which create the most jobs.

The second phase of Deloitte, Haskins & Sells' 1981 study analyzed the cost of creating a new job through the SBIC program. The cost to the Federal Government: $270! These are permanent jobs in private businesses. I am aware of no other enterprise where the Federal Government receives such a return on its investment.

In summary, we have found that small businesses have profited greatly from their use of SBIC dollars and management counseling; also, we have found that the Federal Government has received a great return on its investment in the SBIC program.

The SBIC program represents a unique economic program. It produces the following results: (1) Helps small business; (2) Creates jobs; (3) Stimulates private investment; (4) Develops new technologies; and (5) Generates added tax revenues.

I know of no other Federal program which can claim such economic success.

Now that I have discussed the benefits of the SBIC program to the well being of the nation, I would like to discuss some of the benefits of the SBIC program specifically to the Buffalo area.

To that end I would like to give you some background information on Rand Capital Corporation, its subsidiary, Rand SBIC, and a few companies in its portfolio.

Rand Capital was formed in 1969 by George F. Rand III and myself, both officers at Marine Midland Bank in Buffalo; we raised $1.7 million from prominent local businessmen who became our Board of Directors. In 1971 we decided to go public and raised another $1.7 million. Several of our earliest investments were start-up companies located in the Buffalo area. As the companies were growing, we were learning—first, that these companies needed more money than the original investment; second, these growing companies needed management assistance; third, these new companies took more time to succeed than we anticipated. Because Rand is a public company we are restricted as to the amounts of money invested in a particular company and industry. It became obvious to us that we had to join forces with other venture capital companies not only to keep our start-up companies alive, but also to make new investments. After much research and discussion with people in the venture capital industry it seemed the best route would be for Rand Capital to form a SBIC subsidiary. This was easier said than done; since we are a public company, the SBA took—what seemed to us—an inordinate amount of time—one year—for investigation and scrutiny of our company. Rand Capital received its SBIC license in 1976 and invested $500,000 of its funds into this subsidiary.

Our very first investment, in the Fall of 1969, was a $250,000 loan to a start-up CATV system which now services virtually all the contiguous suburbs of Buffalo. We purchased an 11 percent interest in this company for $13,500. Last year we sold that stock for six million dollars and had our loan paid. This was our first big winner, and it is interesting to note that it took twelve years for it to happen. You've probably heard the axiom about venture capital that lemons ripen quickly, pearls take a long time to cultivate. I might also add that with respect to this cable TV system, it didn't all just happen easily. For along the way we were responsible for a complete change of management and three major financial reorganizations. When we got involved with this company there were fewer than fifteen employees. Today Comax Telcom employs 150 people in an area with 12 percent unemployment.

Although many investments have been made by Rand SBIC, I would like to discuss one particular company—Nanodata Computer Corporation. Copies of three Buffalo newspaper articles are attached as exhibits.

It is one of the more interesting developments in the heart of the City of Buffalo known as the Elm-Oak Corridor. This strip of land which was characterized by the Buffalo Evening News as a "wasteland of demolished tenements" is slowly turning into a high technology park. The first business to locate in downtown Buffalo was Nanodata, a computer manufacturer. Rand Capital invested in this firm in 1971 when it had three employees. In February of this year it had 139 employees and occupied three floors of an 80,000 sq. ft. renovated building at the foot of the Elm-Oak Corridor. The financing package for this company was extremely complicated. It includes an SBA guaranteed bank loan, a Department of Commerce-EDA loan, and the State of New York even helped out by taking title to the building and making it available to Nanodata on extremely favorable terms. Once this company was up and running, a second high-tech firm known as Comptek built a 55,000 sq. ft. building one block north of the Nanodata site. The new building is called High Technology Center. With sales of $7 million, during the year ended March 1978, its sales have tripled to $22 million for the year just ended. Comptek was founded in 1968. Its four founders started with a $500,000 equity investment from M & T Capital, another Buffalo based SBIC, and a SBA guaranteed bank loan of $300,000. Needless to say, that loan has been repaid. Comptek today has 500 employees in an area with 12½ percent unemployment.

So much for little success stories in the Buffalo area. Let me tell you of a struggling company. We have a $150,000 subordinated loan as part of a $750,000 package to a small furniture company in Jamestown, New York. It can trace its history back 175 years. They employ 150 people some of whom have been with the company 40 years. It is a highly leveraged situation with bank debt in excess of $1 million. Last year at 2½ percent over prime they were paying better than 20 percent for money for most of the year. The company experienced a loss of $100,000 after paying an interest bill of nearly $450,000. For this company interest is a double whammy. Without a housing industry their sales have dropped precipitously, and at the same time their balance sheet is being eaten alive by high interest. The employees are on a four-day work week, management are all drawing half salaries, and everyone is wondering how long they are going to be able to last. It is significant to realize that interest rates are a critical issue for a company's survival especially in today's economy. Rapidly rising interest rates during these past year has meant the difference between a company showing a loss rather than a profit at year end, as seen in the case of Sterlingworth Corporation. Therefore, there certainly is need for availability

of SBIC funds to help companies borrow at rates lower than bank prime-plus rates. Most of us in the SBIC industry doubt that we'll ever see single digit prime rates again.

As you listen to the testimony of Mr. Rider, Mr. Koldyke and myself, it must be evident to you members of this Subcommittee on Tax, Access to Equity Capital and Business Opportunities of the House Small Business Committee that SBICs are not passive investors. Most SBICs work closely with the management of portfolio companies—often putting a management team together and sometimes having to replace it with another team as the company grows beyond the first team's capability.

I should also tell you that in all these situations, my management team at Rand became totally available as part-time management to such distressed companies.

As a Governor of the National Association of Small Business Investment Companies, and having spent fourteen years in this industry, I can also tell you that it is quite common for venture capitalists to join with the management of their investments in solving problems and making the day to day decisions that are so critical to survive during times of crisis. All of us have developed considerable skills helping to make sick investments healthy. I can't think of a better way for the government to maximize job creation than by putting its money on the table with ours through the medium of the SBIC program. Most of the investments we make require long incubation periods before they can be ruled successful, and some never succeed; but the fact remains that all businesses, even the giants such as IBM, U.S. Steel, and AT&T, were all once small businesses. Technologies that have revolutionized modern day living can take a long time to develop. Carlson spent twenty years perfecting Xerography, and Leopold Godowsky, who serves on the board of one of our investments, has told me it took him seventeen years to perfect the Kodachrome process for Kodak. So, quite literally, some of the new ventures we invest in require long-term assistance, and in turn we need the long-term support of the SBIC program in repaying our loans.

H.R. 5302 AND THE SBIC PROGRAM

The elements of H.R. 5302 represent five major improvements to the SBIC program which will enhance the operational capacity of SBICs and allow them to provide even better service to small business.

I will review briefly each section of the bill and its importance to the SBIC industry.

ELIMINATION OF THE $35 MILLION LEVERAGE CEILING

The Small Business Investment Act currently restricts the amount of leverage which can be drawn down by any one SBIC to a maximum of $35 million. This ceiling on leverage was $7.5 million at the time the Act was originally passed in 1958; it was raised to $15 million in 1972; and it was increased to the current $35 million level in 1976.

We wholeheartedly endorse the complete elimination of this ceiling for several reasons. First, and most obvious, is the fact that any legislated ceiling of this nature is simply arbitrary, as evidenced by its fluctuations over the years. Clearly, a fixed dollar ceiling has no relationship to market realities and changing economic conditions. In today's economic environment the organization of venture capital funds with $20–$50 or even $100 million in private capital has become a matter of common practice. But SBICs, because of this arbitrary ceiling, are severely restricted as to their size and the size of the investments they can make in small firms. So long as this ceiling is in place it makes little business sense to form a new SBIC with more than a maximum of $11.7 million in private capital. Leverage remains the major incentive for the formation of new SBICs, and, with the standard leverage ratio of 3 to 1, any amount of private capital over $11.7 million cannot be leveraged. The ceiling also creates an implicit restriction on the internal growth of existing SBICs; it is a built-in disincentive to growth through the normal process of capitalizing earnings, and a deterrent to current SBIC owners' increasing their stake in the company. Finally, because SBICs are restricted to investing no more than 20 percent of their private capital in any one small firm, the ceiling imposes an implicit dollar restriction on the maximum investment an SBIC can make in a small business.

In summary, the $35 million ceiling places an arbitrary restriction on the formation of new larger SBICs; it's a disincentive to the growth of existing SBICs; and it restricts the size of investments SBICs can make in growth-oriented small firms. We need to encourage the development of larger professionally managed SBICs with the capacity to make a significant impact on the fast-growth sector of our small busi-

ness economy. That's where the new jobs are created and the new technologies are produced. In order to reach that objective the leverage ceiling should be repealed.

RECOGNITION OF UNREALIZED APPRECIATION

Section 3 of the Bill deals with a different, but very important, aspect of leverage. As I mentioned earlier, the SBIC program is built around the basic feature of access to leverage at a ratio of three times the SBIC's private capital. What constitutes "Private Capital" thus becomes a very important part of this borrowing power equation. Both the Act and SBA regulations currently define private capital as "the combined paid-in capital and paid-in surplus" of an SBIC, and SBA, from time immemorial, has taken a narrow and restrictive view of what qualifies as private capital for purposes of leverage.

The SBIC industry has argued for years that some portion of the appreciated but unrealized values in an SBIC's portfolio should be recognized for leverage purposes. From the industry's point of view this appreciation in the values of an SBIC's investment is the equivalent of paid-in capital, but it simply has not been converted into (realized as) paid-in capital for several very legitimate reasons. In many cases the securities an SBIC holds represent interests in a small firm during its early stages of growth, and it would not make economic sense for the SBIC to forego future appreciation on those investments in return for the short-term advantage of converting limited appreciation into their capital account for leverage purposes. In many other cases, securities held by SBICs may carry a listed value on a recognized securities exchange, but they are restricted by SEC regulations, cannot be sold immediately and the SBIC is precluded from converting them to the form of capital SBA considers qualified for leverage. In still others, a sale of a large amount of these securities might damage the market for all the issuer's shares.

SBA has historically argued that recognition of unrealized appreciation in an SBIC's portfolio would open a Pandora's Box and subject SBA to significant risk since the true valuation of these appreciated holdings is difficult to determine and fluctuations in the values of unseasoned investments can be rapid and frequent.

The SBIC industry shares SBA's concerns, but we believe Section 3 of H.R. 5302 clearly resolves them to the benefit of all parties concerned. First, Section 3 would only recognize the appreciated value of a narrow restricted class of "marketable securities" which are listed on a registered securities exchange or quoted in the quotation system of the National Association of Securities Dealers. This means we are giving recognition to only those securities of more seasoned firms which have reached the public securities markets, have marketability and are openly and publicly valued by the best method our free enterprise system has devised—the scrutiny and due diligence of public buy-and-sell transactions. In our view, this fully resolves the potential problem of inflated valuations for securities which are not actually marketable.

The other issue of concern to SBA is the Agency's potential exposure to risk as a creditor if the appreciated values of these securities dropped substantially due to economic conditions or performance of the portfolio concern. Here again, Section 3 of H.R. 5302 provides ample downside protection to the SBA. This protection takes two forms. First, only 50 percent of the net appreciated value of qualified marketable securities, to a maximum of $10 million, is recognized for leverage purposes under the Bill's formula. In effect, the other 50 percent provides a substantial cushion for SBA's credit position.

In addition, this is further backed up by another provision which says essentially that if the total net unrealized appreciation in the SBIC's portfolio is diluted to a certain failsafe point, then the SBIC is required to increase its private capital to overcome the dilution. In our view, these provisions are a very conservative approach to recognition of appreciated values and they amply protect SBA's creditor position.

I will note at this point, after reviewing the legislation with several of our members and our General Counsel, we do have a recommended technical amendment to the definition of "marketable securities." Mr. Chairman, with your permission, we will submit the suggested changes to you in letter form with supporting explanatory materials.

EXPANDED CASH MANAGEMENT AUTHORITY

Like any other financial institution, SBICs from time to time have funds which are not deployed in portfolio investments or necessary for daily operating expenditures. Under current law, the temporary placement of these funds until they are needed for current operations or investments is narrowly limited to U.S. Govern-

ment securites or certificates of deposit or savings accounts of government insured commercial banks or savings and loans with a maturity of one year or less.

Clearly, these limited options assure absolute safety of these assets, but they are so narrow that they give the SBIC no flexibility whatsoever and, depending on market conditions, can be counter-productive to effective and safe cash management practices.

Section 4 of H.R. 5302 provides a limited degree of latitude for SBIC cash management, while retaining the essential ingredient of safety which is a legitimate concern of the Government. Section 4 would authorize SBICs to place these uninvested funds in two new categories of investment. The first would be repurchase agreements (or repo's) with maturities not exceeding one year which are issued by commercial banks and secured by U.S. Government securities. In addition to safety, repos are a much more flexible security for SBIC cash management since they provide the added feature of immediate liquidity. SBICs can cash-in repos in a matter of days, giving them a security which they can match much more closely to their short-term cash needs. The second category would be in publicly issued securities with maturities of one year or less which are rated AAA by Standard and Poor's or AA by Moody's. These securities would give SBICs the feature of immediate liquidity without the onerous penalties for premature withdrawal which certificates of deposit carry. In our view this change will give SBICs a modicum of necessary cash management flexibility while retaining the degree of safety essential to protect the taxpayers' dollars.

ELIMINATION OF DUAL REGULATIONS

Congress and the SBA have long acknowledged the potential problem of duplicate regulations of SBICs which are publicly-owned and regulated by both the SBA and the SEC under the 1940 Investment Company Act. In the area of affiliate transactions, the SEC's regulations are quite complex and even more demanding than SBA's. SBA has recognized this fact and in cases where an SBIC has obtained an SEC exemption concerning this type of transaction, the SBIC is automatically exempt from the SBA's corresponding regulations.

Section 5 of H.R. 5302 addresses this issue of duplicate SBA and SEC regulations, codifies the existing exemptive regulation of SBA and expands it to include an SBIC which is a "Business Development Company" (BDC) under the new Small Business Investment Incentive Act of 1980. As you know, that Act authorized the creation of a new type of venture capital investment company which would be free from many of the onerous and unrelated regulatory burdens of the 1940 Act which were designed for mutual funds and other types of financial institutions. This initiative, however, re-created the problem of dual regulation by the SBA and SEC, particularly in the complex area of affiliate transactions. H.R. 5302 neatly resolves this issue by granting jurisdiction to the SEC's regulatory coverage. We support this approach as a logical, fair and efficient solution to the problem, as well as a good example of effective co-ordination between two Federal agencies in the regulatory area. This statutory change should help to encourage the formation of larger, publicly-owned SBICs qualified under the 1980 Act, with the ultimate result of an increased flow of venture capital to small business.

INCENTIVE STOCK OPTION LOANS TO EMPLOYEES

This Section (Section 6) of H.R. 5302 would authorize an SBIC to make loans to its employees for the purpose of purchasing stock options in the SBIC, under regulations prescribed by SBA.

As you know, growth in the venture capital industry, and SBICs in particular, has been substantial in the past five year period. One result of this growth has been intense competition for a rather limited pool of qualified, experienced venture capital professionals. Offering an executive compensation plan with stock options is a standard practice in industry today, and this is also true in the venture capital industry. Because most sought after executives—particularly bright, young talent on the way up—do not have accumulated wealth to purchase stock under option plans, most companies also provide an affordable companion loan program through which these executives can exercise their options and acquire a "piece of their company." Congress clearly recognized the virtue of this practice and its potential benefits to the venture capital industry when it passed the Small Business Investment Incentive Act of 1980. That Act specifically authorizes Business Development Companies to make loans to their employees for the purchase of stock options in the company, under rules prescribed by the SEC.

SBICs are now at a serious competitive disadvantage when it comes to employee stock options, and unless the disadvantage is removed the SBIC industry faces the prospect of a severe "talent drain" from its ranks of professional managers. This disadvantage results from the fact that SBICs are currently prohibited from making loans to their employees for any purpose. Under SBA's current regulations, loans to employees for stock options would be both a prohibited transaction and a conflict-of-interest violation.

H.R. 5302 would remedy this disadvantage while providing adequate safeguards to prevent abuse or improper dissipation of an SBIC's funds. The legislation would authorize such loans by an SBIC under regulations similar to those established by the SEC for Business Development Companies. We wholeheartedly endorse this change as a consistent and safe method of assuring stability and growth in the professional ranks of the SBIC industry.

RECOMMENDED AMENDMENT

We do have one substantive amendment to H.R. 5302 that we recommend for consideration by the subcommittee.

Our amendment relates to the organizational structure for administration of the program at the SBA. The Small Business Investment Act of 1958 specifically provided for an Associate Administrator to head the Investment Division of SBA. The legislative history clearly shows that Congress fully intended the Associate Administrator to have separate and distinct responsibility for SBA's investment programs, primarily the SBIC program. Unfortunately, Section 201 of the Act was written in such a way as to be open to interpretation and administrative manipulation.

As a result, during the past 23 years we have seen a series of different organizational arrangements at the SBA where the Agency's investment program responsibilities have stood alone, been combined with field operations, separated, combined with various other financial programs of SBA, reseparated and recombined with another mix of programs. As you might expect, this continuing organizational turmoil has had a serious impact on continuity of policy and regulatory activity as well as morale.

The most recent SBA reorganization, initiated by former Administrator Michael Cardenas, put SBA's investment functions into the office of an Associate Administrator for Finance and Investment. Under the current organizational scheme, one person must assume full policy and program responsibilities for all the following undertakings: (1) The $1.5 billion SBIC program; (2) The $250 million MESBIC program; (3) The $125 million business loan program (direct); (4) The $2.9 billion business loan program (guaranteed); (5) The $5 million loan program for the handicapped (direct); (6) The $15 million loan program for the handicapped (guaranteed); (7) The $45 million economic opportunity loan program (direct); (8) The $60 million economic opportunity loan program (guaranteed); (9) The $10 million energy loan program (direct); (10) The $17 million energy loan program (guaranteed); (11) The $250 million development company loan program (guaranteed); (12) The multi-billion dollar natural disaster loan program; (13) The $1.4 billion surety bond program; (14) The $250 million pollution control financing program; (15) Servicing a $13 billion business loan portfolio; (16) Servicing the multi-billion dollar disaster loan portfolio; and (17) Providing direction to over 2,000 SBA employees involved in financial assistance programs.

Furthermore this list only highlights the enormous span (and burden) of responsibility confronting the Associate Administrator for Finance and Investment. It does not include the day-to-day administrative responsibilities of personnel actions, casework, and congressional letters that flow from this enormous range of multi-billion dollar programs.

My point is simply this. Regardless of the ability of the man holding this Associate Administrator title, and incidentally, the current incumbent is an able individual, no one person can do a truly effective job with all of these programs. Something has to suffer in terms of time and attention, policy direction and day-to-day operations. We know first hand that what suffers are the SBIC/MESBIC programs. This is not intentional or malicious but the problems demand 110 percent of the Associate Administrator's time.

Consequently, in order to restore the original Congressional intent, and as a matter of good management practice, we strongly recommend that Section 4(b) of the Small Business Act be amended by adding the following language prior to the last sentence in that Section:

"One of the Associate Administrators shall be designated at the time of his appointment as the Associate Administrator for Investment and shall be responsible to the Administrator solely for the investment programs of the Administration."

In order to avoid any misunderstanding in the future, we also suggest that the report of H.R. 5302 contain language which makes very clear the Committee's intent that there be a separate Associate Administrator for Investment, responsible only for the investment programs and that he not be given additional, unrelated responsibilities.

CONCLUSION

In conclusion, I would summarize by saying that the SBIC industry is a unique growth industry on the move—providing venture capital to small growth companies, developing new technologies, creating new jobs and generating new tax revenues for the Government.

H.R. 5302 makes substantial strides in improving the legislative design of the program. Passage of this legislation will result in larger, stronger and more professional SBICs providing increased levels of venture investment and management services to the growth industries of tomorrow.

Thank you Congressman Nowak and Congressman Marriott for your sincere interest in the SBIC industry and for introducing this bill; and thank you from the citizens of Buffalo, New York.

BUFFALO EVENING NEWS | BUSINESS FINANCE
Friday, April 6, 1979 Page 11

BUYS BUFFALO BUILDING — John Liebel, left, president of the Nanodata Corp., signs the purchase contract for the Weed Building on Swan Street. Attending the ceremony in City Hall are Donald Ross, center, president of the Buffalo-based Rand Capital Corp., which is a major stockholder in Nanodata, and Mayor Griffin.

Nanodata Corp. Completes Purchase of Weed Building

By MIKE McKATING
News Business Editor

As computer programmers, technicians, secretaries and executives clad in overalls and blue jeans lugged packing boxes, the final elements of Nanodata Corp.'s purchase of the Weed Building were completed in Mayor Griffin's office today.

John T. Liebel Jr., president of Nanodata, and city, state and federal officials and private lenders put the finishing touches this morning on the complex deal which they hope will see a major employer blossom right on the fringes of Buffalo's downtown.

Under the deal, Nanodata purchased the Weed Building, (which the city has renamed One Computer Plaza), formerly the Marine Midland Computer Center and most recently the home of the County Department of Central Police Services.

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THE STRUCTURE of the deal also pumps several million in fresh capital into Nanodata which, along with an expanded line of credit from Chemical Bank, will finance a major expansion by the company.

"This is one of the best things that's happened to the City of Buffalo since I've been mayor, and for a long time before," a beaming Mayor Griffin said as he congratulated Mr. Liebel and Rep. Henry J. Nowak (D-Buffalo) who flew in from Washington for the ceremony.

"It means that business and the financial community has confidence in the City of Buffalo, and it means that we're going to grow," Mayor Griffin said.

"But it never could have happened without Henk Nowak, who hard-dogged that EDA loan all the way," he said.

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THE MAJOR elements of the deal closed this morning are — The New York State Department of Transportation, which owned the Weed Building, transferred it to the State Urban Development Corporation.

—UDC sold the building to Nanodata in return for $300,000 worth of preferred stock and a $100,000 second mortgage. The preferred stock is convertible into a note after the fifth year.

—The City of Buffalo's Local Development Corporation (LDC) will finance a $500,000 renovation of the building to Nanodata's specifications, and will receive $500,000 in preferred stock in return.

—The Federal Economic Development Administration has committed to make a $7.4 million term loan to Nanodata to finance expansion of its manufacturing capability.

—Three private venture capital companies, the J.H. Whitney Co., Citicorp Venture Capital and Sutter-Hill Venture Capital from San Francisco, have invested an additional $1.6 million in Nanodata.

—Chemical Bank has agreed to advance the company a $1 million line of credit secured by inventories and receivables.

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INITIALLY, Nanodata will occupy the first and fifth floors of the five-story building and will continue to lease some space to Central Police Services.

But Nanodata, which now employs 55 persons, expects to increase employment to about 500 within three years.

Nanodata, founded in 1971, has been regarded as a pioneer in the field of research computers since it introduced its QM-1 computer system in 1974.

But the company is now introducing a VMX Model "chameleon" computer which can mimic the characteristics of any other computer. Computer experts expect the Nanodata VMX to become a major contender with such computer names as IBM, Burroughs and NCR.

Nanodata was fast outgrowing its cramped quarters at 2457 Wehrle Dr. in Williamsville, and badly needed more space.

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IT WAS AT this point Mr. Liebel met Lawrence Quinn, the city's director of economic development, through Donald A. Ross, president of the Buffalo-based Rand Capital Corporation, which owns 200,000 shares of Nanodata's common stock.

The basic idea of the deal that was finalized today began to jell almost two years ago in discussions between Mr. Quinn, Mr. Ross and Mr. Liebel.

Eventually Mr. Nowak, State Transportation Commissioner William Hennessey and Deputy Commissioner John Downing and many others worked to bring what city officials hope will be the keystone of a major high technology park to downtown Buffalo.

"From here on in, the whole project is going to be people-intensive. It's a question of finding enough of the right technicians and executives. But if we can do that, we project that our sales could hit $40 million within three years," Mr. Liebel said.

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E—8 THE BUFFALO NEWS January 6, 1980

High Technology Industry Sets Its Sites Downtown

By MIKE McKEATING
News Financial Editor

One of the fastest-growing and most promising industries in the Buffalo area during 1979 was the high technology industry. If you have any doubts of that, just take the Niagara Section of the Thruway and get off at the Elm Street exit. The evidence hits you in the face.

There, on the fringes of downtown Buffalo, in the midst of what was once a wasteland of demolished tenements, stand the headquarters of two high technology industries that weren't there at this time last year.

And at this time next year, a minimum of 250 employees should be working in these two buildings, breathing fresh economic life into an area that hasn't seen any in years.

The two companies are Nanodata Corp. and Comptek Research Inc. Last year's annual review predicted that both companies would move to new headquarters in downtown Buffalo, but actually both deals have worked out more smoothly than anybody but the most stalwart optimist could have expected.

Both the Nanodata and Comptek deals were shepherded to completion by Lawrence W. Quinn, the city's director of economic development.

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THE NANODATA deal came first. During 1978, Quinn heard that the company, then located on Wehrle Drive in Williamsville, was looking for more space and also more capital to develop and market a totally new computer which it had developed.

Quinn also knew that the Weed Building, the former Marine Midland Computer Center at 110 Seneca St., was available. It had been taken by the state Transportation Department for the Elm-Oak Arterial, but the arterial had later been rerouted, and the state now wanted to sell the building.

But the state was asking $1 million, and Nanodata didn't want to tie up that kind of cash when it could be better spent on R&D and marketing.

Undaunted, Quinn and Nanodata President John T. Liebel Jr. worked out a complex deal that gave Nanodata both the building, the cash flow and the new equity capital it needed to bring its new QMX computer to market. The major elements of the deal were:

—**The state Transportation Department** transferred title to the building to the state Urban Developement Corporation.

—**UDC sold the building** to Nanodata in return for $900,000 worth of the company's convertible preferred stock and a $100,000 mortgage.

—**The City of Buffalo** gave Nanodata $500,000 in federal block grant funds to renovate the building, and in return received $500,000 in preferred stock, convertible to a demand note in the 10th year.

—**Three venture capital companies,** the J.H. Whitney Group, Citicorp Venture Capital and Sutter Hill Venture Capital, agreed to give Nanodata $1.6 million in fresh equity capital.

The U.S. Economic Development Administration gave Nanodata a $2.4 million loan, and Chemical Bank Buffalo gave it a $9 million line of credit.

Nanodata moved into the building in April, and now occupies two of the five floors in the 75,000 sq. ft. building. The other three are rented to the County Department of Central Police Services, but as Nanodata's production and sales expand, it will eventually occupy the whole building.

The Common Council celebrated the Nanodata deal by officially renaming 110 Seneca St. "One Computer Park."

Nanodata's employment has doubled since it moved into the building, from 55 to 105.

Production is just now beginning in earnest on the new QMX computer, with the first one scheduled to be delivered this month.

Liebel said the company expects to have sales of $7 million in 1980, and expects employment to double again to 200 by the end of the year. The company's long-range plan calls for employment of 500 and sales of $40 million at the end of three years.

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JUST BEHIND the Nanodata Building, in the block bounded by Ellicott, S. Division, N. Division and Elm streets, another new building is going up.

The buildings, to be called the High Technology Center, is being built with a combination of public and private funds, and its major tenant will be Comptek Research Inc., presently headquartered at 455 Cayuga Road, Cheektowaga.

Comptek designs and makes radar systems for the Navy, and also makes a line of word-processing computers for law firms, called the Barrister.

Comptek is headquartered here, but has operations in Washington, Richmond and Norfolk, Va., and Santa Barbara, Calif. It has a total of about 360 employees, about 125 of them here.

Comptek, like Nanodata, was growing rapidly, and desperately needed more space, but also needed to conserve cash for expansion of sales and production.

Again, Quinn worked out a deal whereby a private developer, Frank J. McGuire, president of Industrial Light & Power Co., put up $250,000 and guaranteed a $1.6 million industrial revenue bond issue.

Ground was broken on a $2 million, 55,000-sq. ft. building on Aug. 21. Comptek expects to move in in April or May, and will take 40,000 of the space, with the other 15,000 sq. ft. being leased to another high-technology tenant.

The building will be called the High Technology Center, and is directly behind the Nanodata Building, in the block bounded by Ellicott, N. Division, S. Division and Elm St.

Comptek is one of Buffalo's fastest-growing high-technology companies. For the 1978-79 fiscal year, which ended March 31, the company had sales record of $11,533,000, a 61 percent increase over the $7,160,000 in sales the previous year.

Henry P. Semmelhack Jr., Comptek president, said the company hopes for sales in the $14 million range in the current fiscal year, which would represent another 22 percent increase.

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OUT IN CLARENCE there are two very interesting high-technology compa-

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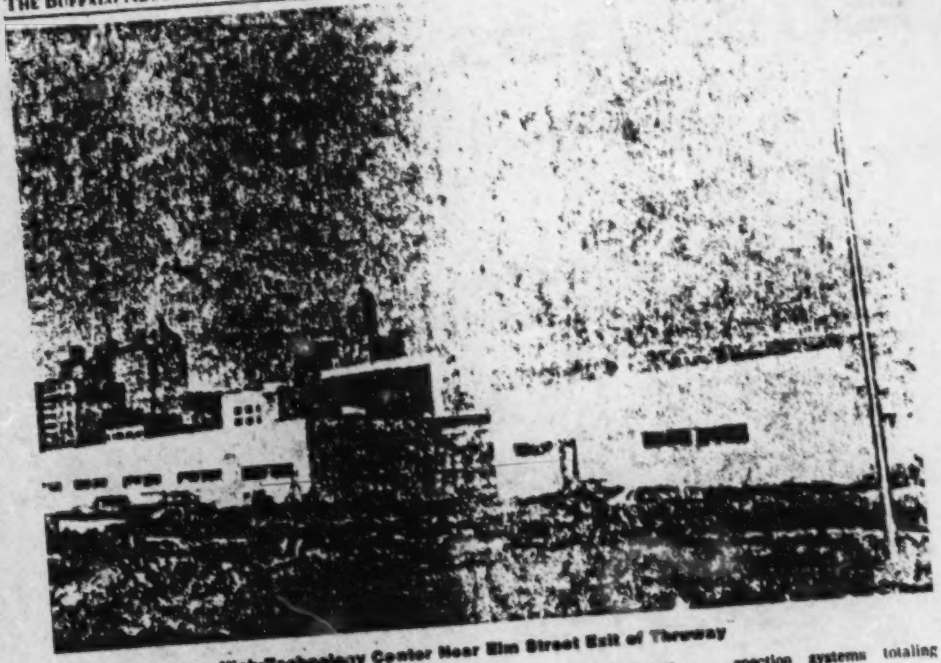
Sunday, January 6, 1980

THE BUFFALO NEWS



Comptek Building High-Technology Center Near Elm Street Exit of Thruway

nies with common roots, and both are thriving in Buffalo's industrial climate.

One is Wilson Greatbatch Ltd., at 1000 Wehrle Dr., a manufacturer of lithium batteries for heart pacemakers and other applications in medicine and industry.

Wilson Greatbatch Ltd. was founded in 1970 by Wilson Greatbatch, the Buffalo scientist who invented the heart pacemaker.

The company has about 220 employees and had sales of about $6.2 million in 1979. It is privately held by the Greatbatch family.

During 1979 Wilson Greatbatch Ltd. formed a new company, Electrochem Industries Inc., to manufacture and market high-energy lithium batteries for the commercial market.

The new batteries, developed to meet the needs of the computer, aerospace, electronics, instrumentation and communications industries, offer higher energy density and cell voltage, said Dr. Charles C. Liang, president of Electrochem.

Greatbatch predicts sales of about $9.5 million for Wilson Greatbatch Ltd. in 1980.

"I also foresee employment growth, but it's hard to say how much."

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AROUND THE CORNER at 10123 Main St. in Clarence is another high-technology company that has common roots with Wilson Greatbatch Ltd.

It is Mennen Medical Inc. Formerly known as Mennen-Greatbatch, it was founded in 1962 by Wilson Greatbatch and Herbert Mennen. Mennen subsequently bought out Greatbatch and changed the name to Mennen Medical.

The company makes all sorts of medical monitoring equipment, such as those used in operating rooms, emergency rooms and intensive care units.

The company has 300 employees in Clarence, 25 elsewhere in the U.S., and 150 in a wholly-owned subsidiary in Israel.

Mennen said the company had sales of about $20 million in 1979, and expects an increase of 25 percent to about $25 million in 1980, "with a proportionate increase in employment."

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ASTRONICS Corporation of East Aurora, a manufacturer of electroluminescent devices, expects to report $8 million in sales for 1979, for about a 25 percent increase over the $6.4 million reported in 1978, and projects about another 25 percent sales growth in 1980.

Astronics currently employs about 180.

Sierra Research Corp., 347 Cayuga Dr., Cheektowaga, is one of the Buffalo area's larger and more mature high-technology companies, having celebrated its 30th birthday last year.

In 1978 Sierra reported sales of $28.9 million, and the stockholders were told at the annual meeting last April that the company was shooting for a 15 percent growth in sales.

Figures for 1979 haven't been released officially yet, but Sierra is expected to report about $30 million in sales for the calendar year, representing about a 34 percent increase over 1978.

Significant developments in 1979 for Sierra included:

—**Receipt of contracts** from two foreign civil aviation agencies for flight inspection systems totaling $4.7 million.

—**The addition of new orders totalling** $6.5 million to a contract received in 1978 for delivery through 1981 of computer-controlled light weight radar tracking systems.

—**New orders totalling** $5.9 million on a contract received in 1978 for delivery through 1982 of NIKE air defense radar modification kits.

—**Institution of a policy** to pay quarterly cash dividends of 5 cents a share on the company's common stock.

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THE BUFFALO NEWS Sunday, April 8, 1979

Business/Finance

Nanodata Deal Is Catalyst for Area

A closing was held Friday on a deal which has already received a lot of attention, but nowhere near as much as it should.

It was probably one of the most unusual deals in the history of American capitalism.

It's a deal which has some of the area's fiscal traditionalists upset, but it's a deal which represents the kind of unfettered, objective, positive thinking that we need to see a lot more of if we're going to turn around this area's long-standing economic decline.

* * *

IT'S A DEAL which is expected to bring 500 new jobs to Buffalo's inner city.

Nor will they be unskilled or menial jobs. They will be high-technology jobs — computer programmers, technicians, engineers — and they will be working in a nice, clean, pollution-free industry — the kind every city dreams of attracting.

In fact, before the deal was even closed the company involved had become a catalyst for other computer companies.

* * *

ONE OF THESE companies, employing nearly 300, is on the verge of announcing that it will move into an adjacent building, helping to form the nucleus of what city officials hope will eventually be a high-technology park stretching from the Elm St. exit of the Thruway all the way to Roswell Park Memorial Institute.

The transaction in question, the details of which were reported in Friday's Buffalo News, is the purchase of the former Weed Building at 110 Seneca St. by Nanodata Corp., a locally-based computer manufacturer.

Nanodata, which currently employs about 55, has just introduced a new line of computers which is expected to increase employment at the Seneca Street building, renamed One Computer Place, to 500 within three years.

* * *

THE REASON the deal was so unusual is because of the unique structuring of the financing. Among other things, it involved both the State Urban Development Corporation and the City of Buffalo acquiring stock in Nanodata.

Buffalo's Business

By Mike McKeating

News Financial Editor

As far as we can determine, it may be the first time in history that an American city has directly acquired stock in a company other than a city-owned public utility.

Actually, the way the deal worked is that Nanodata bought the Weed Building from UDC, but instead of paying cash, gave UDC $900,000 worth of Nanodata preferred stock and a $100,000 second mortgage.

* * *

THE CITY OF BUFFALO, in turn, will use $550,000 in federal block grant money to renovate the Weed Building, and will get $550,000 in Nanodata preferred stock in return.

Based on the investment by UDC and the city, Nanodata was able to get $1.6 million in additional capital from three private venture capital companies and a $1 million line of credit from Chemical Bank to fund its expansion.

The procedure used has already proven so successful that the city is carrying it one step further. It is going to start its own venture capital company.

The city division of economic development will use $500,000 in federal block grants and a $1.5 million Small Business Administration loan to start a Small Business Investment Company, to make venture capital investments in companies willing to set up operations in the city but needing capital.

* * *

A FRIEND of mine recently complained that the idea "smacks of creeping socialism." I told him that I'm not so sure it's not galloping socialism, but I'm all for it. It's the kind of imaginative thinking that we badly need to rejuvenate the Buffalo economy.

A lot of credit for the Nanodata deal has been passed around in recent days, and all of the people mentioned certainly helped make it happen.

But the real credit belongs to two men who have two of the most fertile brains for business and economics that I've ever run across. They are Donald A. Ross, president of Rand Capital Corp., and Larry Quinn, the city's director of economic development.

* * *

RAND CAPITAL was one of Nanodata's first backers, and owns 300,000 shares of its common stock. Under its bylaws it cannot invest any more in Nanodata, so it could not participate directly in the most recent round of financing.

But it was Don Ross and Larry Quinn who conceived of the complicated financial jigsaw puzzle, and then painstakingly put its pieces together during many long days of meetings and nights of brainstorming into the wee hours in front of Don Ross' fireplace.

Mayor Griffin also deserves a lot of credit, because it was his total committment to economic development and to jobs that made it possible for the city to commit so much of the block grant funds to this purpose.

* * *

I HOPE we see many more deals like this, because we need the jobs and the economic growth they produce.

But if the nay-sayers on the Common Council get their way and take control of the block grants away from the mayor, it won't be possible. That would be a shame for the entire city.

BEST AVAILABLE COPY

PANEL CONSISTING OF BRENT T. RIDER, ACCOMPANIED BY WALTER STULTS, AND PETER McNEISH; AND DONALD A. ROSS

TESTIMONY OF BRENT T. RIDER, PRESIDENT, UNION VENTURE CORP., LOS ANGELES, CALIF., AND CHAIRMAN, NASBIC; ACCOMPANIED BY WALTER STULTS, PRESIDENT, AND PETER McNEISH, VICE PRESIDENT, NASBIC

Mr. RIDER. Thank you. Mr. Chairman and members of the committee, thank you for inviting me to testify today on the Small Business Venture Capital Act of 1981, H.R. 5302. As you stated, I am Brent Rider, president of Union Venture Corp. of Los Angeles, Calif., a licensed SBIC with privately held assets of approximately $20 million. I am also chairman of the National Association of Small Business Investment Companies, NASBIC, a trade association which represents the overwhelming majority of all small business investment companies, or SBIC's and minority enterprise investment companies, or MESBICS.

On my right is Walter Stults, as you said, president of NASBIC, and on my far left is Peter McNeish, its executive vice president.

As you know, SBIC's are privately organized, privately capitalized and privately managed venture capital firms which provide equity capital, long-term loans and management assistance to new and growing small business concerns.

SBIC's are licensed under the Small Business Investment Act of 1958 and regulated by the Small Business Administration.

I appear before you today to support strongly H.R. 5302 and will now present an oral summary of my more detailed written testimony.

First, I'd like to take a moment to put our industry's support for H.R. 5302 in proper context. Over the past 23 years, SBIC's have provided over $4 billion in venture capital to some 60,000 companies. There are over 360 active SBIC's with assets of over $1.5 billion today.

We have been investing those assets regularly. In 1981, we put out $333 million, up 12 percent from 1980. In January 1982, we invested $45 million, over 60 percent above the year-earlier equivalent. In summary, we are doing what we're supposed to do.

To measure our impact on the economy as a whole, we commissioned two studies. The first, performed jointly by the international accounting firm, Deloitte, Haskins & Sells, and the consulting firm, Arthur D. Little, Inc., concluded that the companies SBIC's invest in are 10 times as productive as other companies in terms of profits, sales, employment growth, and tax payments.

The second study, done solely by Deloitte, Haskins & Sells, concludes that the Federal Government enjoys a 110-to-1 benefit-to-cost ratio in the small-business investment program. In other words, for every $1 the Government spends, the SBIC program returns $110.

[The information referred to above follows:]

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Haskins+Sells

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THE COST TO THE FEDERAL GOVERNMENT TO INCREASE EMPLOYMENT THROUGH THE SMALL BUSINESS INVESTMENT COMPANY PROGRAM

A previous study by Deloitte Haskins & Sells and Arthur D. Little, Inc. indicated the phenomenal growth of SBIC - financed companies ("portfolio companies") and their contributions to the national economic and employment goals. As the study demonstrated, companies receiving SBIC funds have created growth in employment ten times greater than that of other small firms. Remarkably, this job creation has occurred at a very minor cost per job to the Federal government. This conclusion is based upon the following data.

The cost to the Federal government of the SBIC program includes the direct and indirect cost of administering the program and the loan losses experienced by the government. During the period 1970 to 1979 these costs were as follows:

	Million
Administrative cost - direct	$ 9.3
Administrative cost - indirect	9.3
Loan losses	27.5
Total	$46.1

These expenditures created an increase in employment of 147,730 jobs in portfolio companies during the same period.

Thus, SBIC financing resulted in an employment increase at the cost of $312 per new job created.

This demonstrates that the SBIC program can create jobs and contribute to national employment goals at a very minor cost to the government.

Study Methodology

Indirect costs were based on an SBA study indicating that indirect costs amounted to 100% of direct costs.

The progam's administrative costs are small for the economic activity involved because the Small Business Administration need only license and regulate approximately 350 SBICs; each SBIC provides financing and management assistance to an average of 15 small companies. Government loan losses are minimized because the entire private capital of an SBIC must be exhausted before the government loses any money.

The increase in employment was measured by a previous study by Deloitte Haskins & Sells and Arthur D. Little. To measure the employment increase attributable to SBIC financing, a factor based on total assets and SBIC financing was developed. For each company responding to the survey, total SBIC financing and total assets prior to that financing were used to determine the percentage of assets financed using SBIC capital. The assumption was made that the SBIC financing was used to acquire additional assets rather than to retire existing debt; this seems reasonable in light of the growth nature of most portfolio companies. Total assets financed through SBIC funds as a percentage of total assets was applied to each company's employment increase to determine the increase attributable to SBIC financing. This attribution method was based upon the assumption that SBIC financing made assets available for growth and employment increases. The employment increase attributable to SBIC financing in the surveyed companies was calculated to be 26,618.

Since this calculation measured only the increase attributable to SBIC financing for companies responding to the survey, an extrapolation was made to the entire population of portfolio companies. This extrapolation was based upon the SBIC financing provided to the companies responding to the survey ($312 million) compared to the total SBIC financing provided to all companies. Since substantially all companies responding to the survey had received their SBIC financing in the period 1970 through 1979, total SBIC financing to all companies for that ten year period ($1.734 billion) was used for extrapolation to the entire SBIC population. Extrapolated to the entire population of portfolio companies, the employment increase attributable to SBIC financing was 147,730.

Mr. RIDER. In its second phase, this study also concludes that the cost to the Federal Government of creating a new job is about $300. A CETA job costs nearly $30,000 every year. We create a job for $300 spent once.

The SBIC program represents a unique targeted economic initiative. It helps small businesses, creates jobs, stimulates private investment, develops new technologies, and generates added tax revenues.

We know of no other Federal credit program which produces these results.

One might reasonably ask, with that kind of track record, why is H.R. 5302 necessary? The answer is quite simple. The elements of H.R. 5302 represent five major improvements to the SBIC program.

We've all heard the old adage, "If it ain't broke, don't fix it." However, in this case, the improvements represent significant changes which will enhance the operational capacity of SBIC's and allow them to provide even better service to small business. I will review briefly each section of the bill and its importance to the SBIC industry.

First, elimination of the $35 million leverage ceiling: The Small Business Investment Act currently restricts the amount of leverage which can be drawn down by any one SBIC to a maximum of $35 million. There was no ceiling on leverage at the time the act was originally passed in 1958. A ceiling was first established in 1961 at the level of $4 million, it was raised to $7.5 million in 1967, it was raised to $15 million in 1972, and it was increased to the current $35 million in 1976.

We wholeheartedly endorse the complete elimination of this ceiling for several reasons. First, it is arbitrary and has no relationship to business operations in economic reality. Second, SBIC's which are not permitted to borrow more than three times their private capital cannot leverage more than $11.7 million of private capital. Thus, they have no motivation to attract more capital to their SBIC.

Third, this limitation restricts the amount the SBIC can invest in a company because the SBIC is not permitted to invest more than 20 percent of its capital in any company.

Section 3 of the bill deals with a different but a very important aspect of leverage: the recognition of unrealized appreciation for beverage purposes. As I mentioned earlier, the SBIC program is built around the basic feature of access to leverage at a ratio of three times the SBIC's private capital. What constitutes private capital thus becomes a very important part of this borrowing equation.

Both the Act and the SBA regulations currently define private capital as the combined paid-in capital and paid-in surplus of an SBIC, and SBA, from time immemorial, has taken a narrow and restrictive view of what qualifies as private capital for purposes of leverage.

Much of an SBIC's assets may be in appreciated securities, its reason for being, but only if it sells those securities can their value be included in capital for leverage purposes. Although the values of these securities fluctuate, it seems unrealistic not to include some

portion in the capital calculation to allow a successful SBIC to acquire more funds to make more successful investments.

Accordingly, section 3 proposes to enable this reasonable inclusion by recognizing a very conservative discounted addition to capital for qualified marketable securities.

We support section 3 wholeheartedly, but, Mr. Chairman, with your permission, we will submit suggested changes in the definition of marketable securities in letter form with supporting explanatory material.

Mr. NOWAK. Fine. Without objection, that is so ordered.

[The information referred to above follows:]

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NASBIC

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*EXECUTIVE COMMITTEE

April 19, 1982

The Honorable Henry Nowak, Chairman
Subcommittee on Tax, Access to Equity Capital
and Business Opportunities
1514 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Chairman:

On March 24, I testified before your Subcommittee on H.R. 5302, the Small Business Venture Capital Act of 1981. As I said at that time, the National Association of Small Business Investment Companies strongly supports H.R. 5302. However, we would like to propose a minor amendment to Section 3 of the legislation as it is currently drafted.

Section 3 permits the SBA to recognize, for leverage purposes, a limited amount of the unrealized appreciation in value of the marketable securities held by an SBIC. In the bill, "marketable securities" is defined as those securities listed on a registered exchange or quoted in the quotation system of the National Association of Securities Dealers and supported by at least three registered broker-dealers. Because this definition incorporates only those securities whose values can be readily and publicly determined by the markets, it protects against the potential problem of inflated valuations for securities which are not technically marketable due to regulatory restrictions.

After having explored this issue with members of our Association, we have found that many SBICs hold options or warrants which themselves have established values on a listed securities exchange, are quoted and traded under NASDAQ, or have established markets through registered broker-dealers. Essentially these securities have the same marketability characteristics as straight stock which qualifies for unrealized appreciation treatment under H.R. 5302. Therefore, we recommend that the relevant portion of Section 3 of H.R. 5302 be amended as follows:

"(B) For purposes of this subsection-

"(i) the term 'marketable securities' means any security which is listed on a securities exchange which is registered under the Securities Exchange Act of 1934 or which is quoted in the National Association of Securities Dealers Automated Quotation System (NASDAQ) or which is supported by at least three registered broker-dealers who are currently maintaining a market in said security.

"(ii) the term 'security'-

"(I) means a share of stock in a corporation, or any rights, option or warrant to acquire such stock, but

NASBIC feels that Section 3, amended in this fashion, would more accurately reflect existing conditions in the SBIC industry. The amendment would increase the usefulness of H.R. 5302 without sacrificing any of the safeguards currently provided in the bill.

Again, Mr. Chairman, we deeply appreciate your efforts on behalf of the SBIC industry and small business generally. If you have any questions regarding our proposed amendment, or if we can assist you in any way, please don't hesitate to notify us.

Sincerely,

Brent T. Rider
Chairman, NASBIC

enclosures

Mr. RIDER. Now to expanded cash management authority. To keep active the funds that an SBIC has available to invest but has not yet invested, it must put its funds in short-term instruments. SBICs are restricted today to investing in U.S. Government securities and bank deposits with maturities under 1 year.

Experience has enabled us to conclude that this authority is too restrictive, and section 4 proposes also allowing investments in repos, which are securities issued by banks and secured by U.S. Government securities, and publicly traded securities rated triple-A by Standard and Poor's, or double-A by Moody's.

While enabling SBIC's considerably more flexibility, these changes will not materially increase risk.

On the dual regulation issue, publicly owned SBIC's under the Investment Company Act of 1940 have long been subjected to regulation both by SBA and the SEC, and the SBA has long recognized that transactions permitted exemptions by the SEC would be in compliance with the spirit of SBA's own regulations.

Section 5 codifies the existing exempted provisions and resolves the dual regulation issue created by the Small Business Investment Incentive Act of 1980, by granting jurisdiction over business development companies which are also SBIC's to the SEC. This change should help to encourage the formation of larger publicly owned SBIC's with the ultimate result of an increased flow of venture capital to small businesses.

On incentive stock options, section 6 would allow a SBIC to make loans to its employees to exercise stock options under regulations of SBA. The recent rapid growth of the venture capital industry has led to severe competition for qualified SBIC executives; yet, SBIC's are severely restricted from providing incentives to attract and keep these people because they are not permitted to lend to their employees under any circumstances. Because the young executive does not typically have the funds required to exercise his options, a SBIC, unlike a company in nearly any other industry, may not make those options attractive by enabling their exercise.

H.R. 5302 would remedy this disadvantage while providing adequate safeguards to prevent abuse or improper dissipation of a SBIC's funds. The legislation would authorize such loans by a SBIC under regulations similar to those established by the SEC for business development companies.

We wholeheartedly endorse this change as a consistent and safe method of assuring the stability and growth in the professional ranks of the SBIC industry.

We do have one substantive amendment to recommend, Mr. Chairman, for your consideration and that of your committee. Although the spirit of the Small Business Investment Act of 1958 provided for an Associate Administrator for Investment at the Small Business Administration, our industry has seldom had one who is only that.

In the most recent incarnation under former Administrator Cardenas, we had an Associate Administrator for Finance and Investment. In addition to the SBIC program, he also had and has under his control the $2.9 billion bank-guaranteed regular business loan program; $125 million direct regular business loan program; a $15 million bank-guaranteed handicapped loan program; a $5 million

direct handicap loan program; and about nine others that are listed here.

Although the current Associate Administrator is an able man, neither he nor any other mortal can handle all these programs and their attendant personnel and administrative programs. The SBIC program suffers in contravention of the 1958 act's intent. Therefore, we recommend that section 4(b) of the Small Business Act be amended by adding the following language prior to the last sentence thereof, and I quote: "One of the Associate Administrators shall be designated at the time of his appointment as the Associate Administrator for Investment and shall be responsible to the Administrator solely for the investment programs of the Administration."

In conclusion, I would summarize by saying that the SBIC industry is a unique growth industry on the move, providing venture capital to small growth companies, developing new technologies, creating new jobs, and generating new tax revenues for the Government.

The legislative design of the program is not perfect. From 1958 it has required fine tuning to meet changing economic conditions and improvements in modern business practices. H.R. 5302 has made substantial strides improving the program. Passage of this legislation will result in larger, stronger, and more professional SBIC's providing increased levels of venture capital, investment, and management services to the growth industries of tomorrow.

I commend you, Mr. Chairman and Mr. Marriott, for introducing this bill, and thank you for the opportunity to testify today.

Mr. NOWAK. Thank you very much.

[The prepared statement of Mr. Rider and attachments follow:]

PREPARED STATEMENT OF BRENT T. RIDER, PRESIDENT, UNION VENTURE CORP., LOS ANGELES, CALIF., AND CHAIRMAN, NASBIC

Mr. Chairman and members of the committee, thank you for inviting me to testify today on the "Small Business Venture Capital Act of 1981" (H.R. 5302).

I am Brent Rider, President of Union Venture Corporation of Los Angeles, California, a licensed SBIC with privately-held assets of $20 million. I am also Chairman of the National Association of Small Business Investment Companies, a trade association which represents the overwhelming majority of all Small Business Investment Companies (SBIC's) and Minority Enterprise Small Business Investment Companies (MESBIC's).

As you know, SBIC's are privately organized, privately capitalized and privately managed venture capital firms which provide equity capital, long-term loans and management assistance to new and growing small business concerns. SBIC's are licensed under the Small Business Investment Act of 1958 and regulated by the Small Business Administration.

I appear before you today to strongly support H.R. 5302, and I'd like to take a moment to put our industry's support in proper context.

RECORD OF THE SBIC INDUSTRY

Growth and investment levels.—Over the past 23 years, SBIC's have provided over $4 billion in venture capital to some 60,000 small business concerns. On December 31, 1981, there were 362 active SBIC's with assets of more than $1.5 billion, almost equally divided between private capital and SBA-provided loans (or leverage).

These bare numbers are rather impressive for a relatively young industry, but more important is the fact that the industry is growing and investing more dollars today than ever before. In calendar 1981, SBIC's put out $333 million—up 12 percent from 1980, the busiest previous year. In January 1982, SBIC's invested $45 million, an all-time monthly record—more than 60 percent above the January 1981 level.

So—despite the current cloudy economic skies, hundreds of SBIC's and tens of thousands of small business owners are clearly bullish on the long-term future. Both the suppliers of venture capital and the entrepreneurs who utilize it are placing their bets on the ability of innovative, well-managed small firms to grow and be profitable.

I should also mention that new SBIC's, with higher levels of private capital, have been licensed at an increasing rate during the past three years, and more applications are in the pipeline. Furthermore, there is more private capital in the program now than ever before—almost $750 million, and that is twice as much as the industry had six years ago.

Economic impact of SBIC's.—Two years ago NASBIC commissioned a study of the economic impact of SBIC financing on small businesses. The study was conducted by the international accounting firm of Deloitte, Haskins & Sells and the ecomomic consulting firm of Arthur D. Little, Inc. In summary, the study demonstrated that portfolio companies in which SBIC's invested grew about ten times as fast as average small businesses in terms of profits, sales, employment, and tax payments.

Cost-benefit to the Government.—Last year, Deloitte, Haskins & Sells followed up the 1980 study with two others. The first one computed the direct costs and the direct benefits of the SBIC program to the Federal Government. The accounting firm found that the Federal Government spent $4 million on the SBIC program in 1979: half was the cost of administering the program; the other $2 million was SBA's losses on its loans to SIBCs. In return for that $4 million, however, the Federal Government received a total of $440 million from increased taxes paid by SBIC's, their portfolio companies, and their employees. Clearly, a 110 to 1 benefit-cost ratio represents an attractive investment for the Federal Government.

Job creation.—Professor David L. Birch of MIT has found that between 1969 and 1976, 80 percent of all new new jobs were created by small firms less than four years old. Mr. Chairman, I am submitting a copy of Professor Birch's recent article in the Fall 1981 issue of The Public Interest for the record.

Let me relate that landmark finding to the SBIC program. SBA has compiled data on SBIC-assisted firms for 1981 and found that 67 percent of SBIC dollars went to firms four years old or younger. It is evident that SBIC dollars are going overwhelmingly to those firms which create the most jobs.

The second phase of Deloitte, Haskins & Sells' 1981 study analyzed the cost of creating a new job through the SBIC program. The cost to the Federal Government: about $300. And these are permanent jobs in private businesses. I am aware of no other enterprise where the Federal Government receives an equivalent bang for the buck.

To sum up: we have found, first, that small businesses have profited greatly from their use of SBIC dollars and management counseling; and, second, that the Federal Government has also made a tremendous return on its investment in the SBIC program.

The SBIC program represents a unique, targeted economic initiative. It helps small business, creates jobs, stimulates private investment, develops new technologies and generates added tax revenues. We know of no other Federal credit program which produces these results.

May I digress for a moment at this point? On behalf of the SBIC industry, I wish to express our appreciation to Chairman Nowak and to Mr. Marriott for their leadership in obtaining the Small Business Committee's support for a higher level of funding for SBICs for fiscal 1983.

H.R. 5302 AND THE SBIC PROGRAM

One might reasonably ask—with that kind of a track record, why is H.R. 5302 necessary? The answer is quite simple: The elements of H.R. 5302 represent five improvements to the SBIC program.

We've all heard the old adage "If it ain't broke, don't fix it." However, in this case, the five proposed amendments to the 1958 act represent significant changes which will enhance the operational capacity of SBICs and allow them to provide even better service to small business.

I will review briefly each section of the bill and its importance to the SBIC industry.

ELIMINATION OF THE $35 MILLION LEVERAGE CEILING

The Small Business Investment Act currently restricts the amount of leverage which can be drawn down by any one SBIC to a maximum of $35 million. There was no ceiling on leverage at the time the Act was originally passed in 1958. A ceiling

was first established in 1961 at the level of $4 million; it was raised to $7.5 million in 1967; it was raised again in 1972 to $15 million; and it was increased to the current $35 million level in 1976.

We wholeheartedly endorse the complete elimination of this ceiling for several reasons. First, and most obvious, is the fact that any legislated ceiling of this nature is simply arbitrary, as evidenced by its fluctuations over the years. Clearly, a fixed dollar ceiling has no relationship to market realities and changing economic conditions. In today's economic environment the organization of venture capital funds with $20 to $50 or even $100 million in private capital has become a matter of common practice. But SBICs, because of this arbitrary ceiling, are severely restricted as to their size and the size of the investments they can make in small firms. So long as this ceiling is in place it makes little business sense to form a new SBIC with more than a maximum of $11.7 million in private capital. Leverage remains the major incentive for the formation of new SBICs, and, with the standard leverage ratio of 3 to 1, any amount of private capital over $11.7 million cannot be leveraged. The Ceiling also creates an implicit restriction on the internal growth of existing SBICs; it is a built-in disincentive to growth through the normal process of capitalizing earnings, and a deterrent to current SBIC owners' increasing their stake in the company. Finally, because SBICs are restricted to investing no more than 20 percent of their private capital in any one small firm, the ceiling imposes an implicit dollar restriction on the maximum investment an SBIC can make in a small business.

In summary, the $35 million ceiling places an arbitrary restriction on the formation of new, larger SBICs; it's a disincentive to the growth of existing SBICs; and it restricts the size of investments SBICs can make in growth-oriented small firms. We need to encourage the development of larger professionally managed SBICs with the capacity to make a significant impact on the fast-growth sector of our small business economy. That's where the new jobs are created and the new technologies are produced. In order to reach that objective the leverage ceiling should be repealed.

RECOGNITION OF UNREALIZED APPRECIATION

Section 3 of the Bill deals with a different, but very important, aspect of leverage. As I mentioned earlier, the SBIC program is built around the basic feature of access to leverage at a ratio of three times the SBIC's private capital. What constitutes "Private Capital" thus becomes a very important part of this borrowing power equation. Both the Act and SBA regulations currently define private capital as "the combined paid-in capital and paid-in surplus" of an SBIC, and SBA, from time immemorial, has taken a narrow and restrictive view of what qualifies as private capital for purposes of leverage.

The SBIC industry has argued for years that some portion of the appreciated but unrealized values in an SBIC's portfolio should be recognized for leverage purposes. From the industry's point of view this appreciation in the values of an SBIC's investment is the equivalent of paid-in capital, but it simply has not been converted into (realized as) paid-in capital for several very legitimate reasons. In many cases the securities an SBIC holds represent interests in a small firm during its early stages of growth, and it would not make economic sense for the SBIC to forego future appreciation on those investments in return for the short-term advantage of converting limited appreciation into their capital account for leverage purposes. In many other cases, securities held by SBICs may carry a listed value on a recognized securities exchange, but they are restricted by SEC regulations, cannot be sold immediately and the SBIC is precluded from converting them to the form of capital SBA considers qualified for leverage. In still others, a sale of a large amount of these securities might damage the market for all the issuer's shares.

SBA has historically argued that recognition of unrealized appreciation in an SBIC's portfolio would open a Pandora's Box and subject SBA to significant risk since the true valuation of these appreciated holdings is difficult to determine and fluctuations in the values of unseasoned investments can be rapid and frequent.

The SBIC industry shares SBA's concerns, but we believe Section 3 of H.R. 5302 clearly resolves them to the benefit of all parties concerned. First, Section 3 would only recognize the appreciated value of a narrow restricted class of "marketable securities" which are listed on a registered securities exchange or quoted in the quotation system of the National Association of Securities Dealers. This means we are giving recognition to only those securities of more seasoned firms which have reached the public securities markets, have marketability and are openly and publicly valued by the best method our free enterprise system has devised—the scrutiny and due diligence of public buy-and-sell transactions. In our view, this fully resolves

the potential problem of inflated valuations for securities which are not actually marketable.

The other issue of concern to SBA is the Agency's potential exposure to risk as a creditor if the appreciated values of these securities dropped substantially due to economic conditions or performance of the portfolio concern. Here again, Section 3 of H.R. 5302 provides ample downside protection to the SBA. This protection takes two forms. First, only 50% of the net appreciated value of qualified marketable securities, to a maximum of $10 million, is recognized for leverage purposes under the bill's formula. In effect, the other 50% provides a substantial cushion for SBA's credit position.

In addition, this is further backed up by another provision which says essentially that if the total net unrealized appreciation in the SBIC's portfolio is diluted to a certain failsafe point, then the SBIC is required to increase its private capital to overcome the dilution. In our view, these provisions are a very conservative approach to recognition of appreciated values and they amply protect SBA's creditor position.

I will note at this point, after reviewing the legislation with several of our members and our General Counsel, we do have a recommended technical amendment to the definition of "marketable securities." Mr. Chairman, with your permission, we will submit the suggested changes to you in letter form with supporting explanatory materials.

EXPANDED CASH MANAGEMENT AUTHORITY

Like any other financial institution, SBIC's from time to time have funds which are not deployed in portfolio investments or necessary for daily operating expenditures. Under current law, the temporary placement of these funds until they are needed for current operations or investments is narrowly limited to U.S. Government securities or certificates of deposit or savings accounts of government insured commercial banks or savings and loans with a maturity of one year or less.

Clearly, these limited options assure absolute safety of these assets, but they are so narrow that they give the SBIC no flexibility whatsoever and, depending on market conditions, can be counter-productive to effective and safe cash management practices.

Section 4 of H.R. 5302 provides a limited degree of latitude for SBIC cash management, while retaining the essential ingredient of safety which is a legitimate concern of the Government. Section 4 would authorize SBIC's to place these uninvested funds in two new categories of investment. The first would be repurchase agreements (or repos) with maturities not exceeding one year which are issued by commercial banks and secured by U.S. Government securities. In addition to safety, repos are a much more flexible security for SBIC cash management since they provide the added feature of immediate liquidity. SBIC's can cash-in repos in a matter of days, giving them a security which they can match much more closely to their short-term cash needs. The second category would be in publicly issued securities with maturities of one year or less which are rated AAA by Standard and Poor's or AA by Moody's. These securities would give SBIC's the feature of immediate liquidity without the onerous penalties for premature withdrawal which certificates of deposit carry. In our view this change will give SBIC's a modicum of necessary cash management flexibility while retaining the degree of safety essential to protect the taxpayers' dollars.

ELIMINATION OF DUAL REGULATIONS

Congress and the SBA have long acknowledged the potential problem of duplicate regulations of SBICs which are publicly-owned and regulated by both the SBA and the SEC under the 1940 Investment Company Act. In the area of affiliate transactions, the SEC's regulations are quite complex and even more demanding than SBA's. SBA has recognized this fact and in cases where an SBIC has obtained an SEC exemption concerning this type of transaction, the SBIC is automatically exempt from the SBA's corresponding regulations.

Section 5 of H.R. 5302 addresses this issue of duplicate SBA and SEC regulations, codifies the existing exemptive regulation of SBA and expands it to include an SBIC which is a "Business Development Company" (BDC) under the new Small Business Investment Incentive Act of 1980. As you know, that Act authorized the creation of a new type of venture capital investment company which would be free from many of the onerous and unrelated regulatory burdens of the 1940 Act which were designed for mutual funds and other types of financial institutions. This initiative, however, re-created the problem of dual regulation by the SBA and SEC, particular-

ly in the complex area of affiliate transactions. H.R. 5302 neatly resolves this issue by granting jurisdiction to the SEC's regulatory coverage. We support this approach as a logical, fair and efficient solution to the problem, as well as a good example of effective co-ordination between two Federal agencies in the regulatory area. This statutory change should help to encourage the formation of larger, publicly-owned SBICs qualified under the 1980 Act, with the ultimate result of an increased flow of venture capital to small business.

INCENTIVE STOCK OPTION LOANS TO EMPLOYEES

This Section (Section 6) of H.R. 5302 would authorize an SBIC to make loans to its employees for the purpose of exercising options to purchase stock in the SBIC, under regulations prescribed by SBA.

As you know, growth in the venture capital industry, and SBICs in particular, has been substantial in the past five year period. One result of this growth has been intense competition for a rather limited pool of qualified, experienced venture capital professionals. Offering an executive compensation plan with stock options is a standard practice in industry today, and this is also true in the venture capital industry. Because most sought after executives—particularly bright, young talent on the way up—do not have accumulated wealth to purchase stock under option plans, most companies also provide an affordable companion loan program through which these executives can exercise their options and acquire a "piece of their company." Congress clearly recognized the virtue of this practice and its potential benefits to the venture capital industry when it passed the Small Business Investment Incentive Act of 1980. That Act specifically authorizes Business Development Companies to make loans to their employees to purchase stock in the company under a stock option plan, within rules prescribed by the SEC.

SBICs are now at a serious competitive disadvantage when it comes to employee stock options, and unless the disadvantage is removed, the SBIC industry faces the prospect of a severe "talent drain" from its ranks of professional managers. This disadvantage results from the fact that SBICs are currently prohibited from making loans to their employees for any purpose. Under SBA's current regulations, loans to employees to exercise stock options would be both a prohibited transaction and a conflict-of-interest violation.

H.R. 5302 would remedy this disadvantage while providing adequate safeguards to prevent abuse or improper dissipation for an SBIC's funds. The legislation would authorize such loans by an SBIC under regulations similar to those established by the SEC for Business Development Companies. We wholeheartedly endorse this change as a consistent and safe method of assuring stability and growth in the professional ranks of the SBIC industry.

RECOMMENDED AMENDMENT

We do have one substantive amendment to H.R. 5302 that we recommend for consideration by the Subcommittee.

Our amendment relates to the organizational structure for administration of the program at the SBA. The Small Business Investment Act of 1958 specifically provided for an Associate Administrator to head the Investment Division of SBA. The legislative history clearly shows that Congress fully intended the Associate Administrator to have separate and distinct responsibility for SBA's investment programs, primarily the SBIC program. Unfortunately, Section 201 of the Act was written in such a way as to be open to interpretation and administrative manipulation.

As a result, during the past 23 years we have seen a series of different organizational arrangements at the SBA where the Agency's investment program responsibilities have stood alone, been combined with field operations, separated, combined with various other financial programs of SBA, reseparated and recombined with another mix of programs. As you might expect, this continuing organizational turmoil has had a serious impact on continuity of policy and regulatory activity as well as morale.

The most recent SBA reorganization, initiated by former Administrator Michael Cardenas, put SBA's investment functions into the office of an Associate Administrator for Finance and Investment. Under the current organizational scheme, one person must assume full policy and program responsibilities for all the following undertakings:

1. The $1.5 billion SBIC program.
2. The $250 million MESBIC program.
3. The $125 million business loan program (direct).
4. The $2.9 billion business loan program (guaranteed).

5. The $5 million loan program for the handicapped (direct).
6. The $15 million loan program for the handicapped (guaranteed).
7. The $45 million economic opportunity loan program (direct).
8. The $60 million economic loan program (guaranteed).
9. The $10 million energy loan program (direct).
10. The $17 million energy loan program (guaranteed).
11. The $250 million development company loan program (guaranteed).
12. The multi-billion dollar natural disaster loan program.
13. The $1.4 billion surety bond program.
14. The $250 million pollution control financing program.
15. Servicing a $13 billion business loan portfolio.
16. Servicing the multi-billion dollar disaster loan portfolio.
17. Providing direction to over 2,000 SBA employees involved in financial assistance programs.

Furthermore this list only highlights the enormous span (and burden) of responsibility confronting the Associate Administrator for Finance and Investment. It does not include the day-to-day administrative responsibilities of personnel actions, casework, and congressional letters that flow from this enormous range of multi-billion dollar programs.

My point is simply this: Regardless of the ability of the man holding this Associate Administrator title, and incidentally, the current incumbent is an able individual, no one person can do a truly effective job with all of these programs.

Something has to suffer in terms of time and attention, policy direction and day-to-day operations. We know first hand that what suffers are the SBIC/MESBIC programs. This is not intentional or malicious but the problems demand 110 percent of the Associate Administrator's time.

Consequently, in order to restore the original Congressional intent, and as a matter of good management practice, we strongly recommend that Section 4(b) of the Small Business Act be amended by adding the following language prior to the last sentence in that Section:

"One of the Associate Administrators shall be designated at the time of his appointment as the Associate Administrator for Investment and shall be responsible to the Administrator solely for the investment programs of the Administration."

In order to avoid any misunderstanding in the future we also suggest that the report on H.R. 5302 contain language which makes very clear the Committee's intent that there be a separate Associate Administrator for Investment, responsible only for the investment programs and that he not be given additional, unrelated responsibilities.

CONCLUSION

In conclusion, I would summarize by saying that the SBIC industry is a unique growth industry on the move—providing venture capital to small growth companies, developing new technologies, creating new jobs and generating new tax revenues for the Government.

The legislative design of the program is not perfect—from 1958, it has required "fine tuning" to meet changing conditions. H.R. 5302 makes substantial strides in improving the program. Passage of this legislation will result in larger, stronger and more professional SBICs providing increased levels of venture investment and management services to the growth industries of tomorrow.

I commend you Mr. Chairman, and Mr. Marriott, for introducing this bill, and thank you for the opportunity to testify today.

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CONTENTS

Who Creates Jobs?	*David L. Birch*	3
Refugee Resettlement: The Infighting in Washington	*Amitai Etzioni*	15
When Science Progresses and Bureaucracies Lag—the Case of Cancer Research	*David Salsburg & Andrew Heath*	30
Federal Credit and the "Shadow Budget"	*Herman B. Leonard & Elizabeth H. Rhyne*	40
What To Do When Energy Prices Rise Again	*Robert E. Hall & Robert S. Pindyck*	59
The Global 2000 Controversy	*Katherine Gillman/ Julian L. Simon*	71
Contributors		70
Fall Books: A Special Supplement		90

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Who creates jobs?

DAVID L. BIRCH

As a nation, we must create about 15 million new jobs in the 1980's to employ all of our expanding adult population. This is less than the 19 million we created in the 1970's to absorb "war babies" into the labor force, but it is still quite a large number. Assuming that present attitudes toward government extend at least a few years into the decade, the government sector as a whole will produce no more than one-quarter of the needed 15 million. The private sector will have to produce the rest. All of this will have to take place during a period in which the structure of the U.S. economy is undergoing very basic changes.

As a group of us at the M.I.T. Program on Neighborhood and Regional Change began to think about how the nation will meet this challenge, we came to appreciate how little we knew about the processes by which job creation takes place. Most students of the economy have tended to focus on the aggregate measures of economic change flowing out of the GNP accounts, and have not probed the activities of the individual companies that make it all happen. These analysts may guess about what kinds of corporate behavior are causing shifts, but they never really know for sure.

On the other end of the spectrum, those who have studied the behavior of individual corporations rarely have added up the firms

to see how they come together to create the whole. "Input-output analysis" is one of the major exceptions to this, focusing as it does on transactions between businesses in the economy. Welcome as this innovation has been, it has suffered (as have other attempts to aggregate parts to form economic wholes) from the enormous cost of collecting the necessary data. As a result, it tends to be out of date, and its results are expressed in terms of transactions between whole industries, not between firms.

Our inability to understand the gap between the "micro" economy and "macro" economy is now seriously hampering efforts to develop policies that will generate jobs for the people and the places that need them, without causing inflation at the same time. We know very little about who the major job creators are, where they are active, who controls those jobs, and who is most likely to respond to changes in economic policy. In the absence of such knowledge, national policy has been to stimulate the entire economy as though it acted as a single unit, using instruments like broad tax incentives, easier access to money, and public works programs of various sorts. This can be a very expensive and inflationary approach if, in fact, most of the recipients do not use the incentives to increase employment and productivity. What we need, and have lacked, is the ability to focus our incentives on those who will make good use of them without wasting taxpayers' monies on those who will not.

Frustrated by the inability to relate micro to macro, and thereby to discover how change takes place, our group at M.I.T. began casting about for a new data source that would permit us to analyze inexpensively a large sample of the entire corporate population, one establishment at a time. Our search uncovered the so-called DMI file created by the Dun and Bradstreet corporation. The file contains records for about four million establishments, about 80 percent of the total recognized establishments in the country. We devised a way to combine the data for each establishment for four different years (1969, 1972, 1974, 1976) to obtain a history of the development of each establishment during this period. In the process we added in new firms that were formed along the way, yielding a total of about 5.6 million establishments over the seven-year period. We also edited the records extensively to eliminate establishments for which the data seemed at all questionable. When we were done, we were able to trace what happened to the employment, sales industry, corporate affiliation, age, and location of each establishment over this time. By aggregating establishments, we could see who was contributing to job growth in different periods and places.

TABLE I. *Percentage of Job Losses and Gains by Growth Rate for States*[1]

STATE GROWTH RATE[2]	FAST	MODERATE	SLOW	DECLINE	U.S. AVERAGE
1969–72:					
Gains	13.8%	10.9%	8.5%	7.5%	10.4%
Losses	8.3	8.0	7.7	8.4	8.1
Net	5.5	2.9	.8	–.9	2.3
1972–74:					
Gains	12.4%	10.1%	9.0%	—	10.9%
Losses	7.2	7.2	7.6	—	7.2
Net	5.2	2.9	1.4	—	3.7
1974–76:					
Gains	15.1%	11.4%	10.7%	8.3%	11.2%
Losses	8.9	8.7	9.7	9.3	9.2
Net	6.2	2.7	1.0	–1.0	2.0

[1] Source: M.I.T. Program on Neighborhood and Regional Change.
[2] The four classes of employment change are: Fast (over 4 percent per year), Moderate (2 to 4 percent per year), Slow (0 to 2 percent per year), and Decline (less than 0 percent per year). On the average, this breakdown divides states into four roughly equal groups, although the size of the groups in any particular year is sensitive to the business cycle.

Job creation is what really matters

For any particular place, it turns out that there are six quite different ways that an establishment can affect an area's job base. On the plus side, jobs are added to the pool each year whenever a new firm starts up, an existing firm expands, or a firm located elsewhere moves in. Jobs are lost whenever an establishment closes its doors, lays off people, or moves out. We have come to call these six "job flows": *births* (a new firm starting), *expansions, in-migrants, deaths* (an existing firm closing its doors), *contractions,* and *out-migrants.* The extent to which an area's job pool expands or contracts in total over the year depends on the relative balance between these flows during the year.

We discovered a number of interesting things about the job flows. First, *virtually none of the employment change in an area is due to firms moving,* in the sense of hiring a moving van and relocating. Many firms move short distances each year, but virtually none move from one metropolitan or rural area to another. When a move does occur, it is widely publicized in the press, and it is easy (without evidence to the contrary) to begin to pin all of an area's economic woes on the fleeing firm. Any hard look at the numbers, however, will show that fleeing firms take only a small number of jobs with

them, and that for every firm that flees there tends to be another firm with a similar number of jobs moving in. The net effect of firm "migration" is thus negligible relative to the job base (and the other job flows) for most places.

The second striking phenomenon observed in the analysis of employment change is the constancy of job losses. Every area in the United States seems to lose jobs at about the same rate, regardless of how rapidly the net job pool is expanding or contracting. Table I sorts states into different groups by growth-rate and displays the gains and the losses for each group in each of the three periods studied. As can be seen, virtually all the differences in the net change are due to differences in the gain rates, the sum of the loss rates being remarkably similar across states. There is a variation in average loss rates over time with the business cycle in the expected directions, but all states seem to float up and down together on the loss side, varying between seven and nine percent.

The same phenomenon appears to hold across cities, and even within them. Table II summarizes the loss and gain rates for ten metropolitan areas for which the neighborhood location of each business has been located. The differences in loss rates are relatively small, and if anything the more rapidly growing areas also experience the highest losses. Houston and Charlotte show somewhat higher loss rates than Worcester and New Haven, for example. Again, it is the variation in the gain rates that is so large, the rapidly growing areas replacing lost jobs at two or three times the rate of the declining ones. The same general phenomenon is ob-

TABLE II. *Percentage of Firms Gained and Lost in Ten Metropolitan Areas, 1972-76*[1]

AREA[2]	PERCENT GAIN	PERCENT LOSS	PERCENT NET
Houston	62.7%	35.7%	27.0%
Charlotte	48.0	40.4	7.5
Dayton	36.4	31.4	5.1
Rochester	33.7	29.3	4.5
Boston	37.4	33.7	3.8
Baltimore	36.5	32.9	3.5
Hartford	36.6	35.5	1.1
Worcester	24.6	25.1	– .5
New Haven	27.0	29.5	–2.6
Greenville	26.9	35.1	–8.4
U.S. Average	37.0%	33.7%	4.1%

[1] Source: M.I.T. Program on Neighborhood and Regional Change.
[2] Standard Metropolitan Statistical Areas.

served for the central cities and suburbs within these metropolitan areas.

The average loss rate is also quite high. An eight percent loss every year means that half of an area's jobs and establishments must be replaced every five years for the area simply to break even. We seem to have developed an economic system in which experimentation and risk-taking are very common. As a consequence, we experience and tolerate very high failure rates. The more dynamic the local economy (e.g., Houston) the greater the risk-taking and the greater the proportion of firms that fail. It could easily be argued (without being facetious) that one of our greatest strengths as a nation is our capacity for failure—the grace and even enthusiasm with which we accept those who try and fail and come back to try again. To our counterparts in the industrial world, this churning in our system seems extraordinary. We take it for granted, and at times even try to stifle it under the misguided banner labeled "job retention." *The reality is that our most successful areas are those with the highest rates of innovation and failure, not the lowest.* Areas that are declining are not declining because their rates of loss are higher. They are declining because they are not competing effectively for new jobs.

Those small, volatile job replacers

Since we turn over such a large proportion of our job base every year—in all industries and all areas—the overall character of our economy is affected quite quickly by the nature of the job replacers. It no longer takes generations to transform our economy—only a decade or two. We must thus focus our attention on the job replacers. Who are they? In what sectors of the economy are they found? How big are they? How old are they? Where are they located?

For one thing, job replacers tend to be small. Of all the net new jobs created in our sample of 5.6 million businesses between 1969 and 1976, two-thirds were created by firms with twenty or fewer employees, and about 80 percent were created by firms with 100 or fewer employees (see Table III). Smaller businesses more than offset their higher failure rates with their capacity to start up and expand dramatically. Larger businesses, in contrast, appear rather stagnant. They may be expanding output with more capital equipment (although those who study productivity suggest that this has not been the case recently) or they may expand by opening opera-

TABLE III. *Percentage of Jobs Created by Size of Firm and Region* [1]

Number of Employees in Firm	Percent of Jobs Created				
	Northeast	North Central	South	West	US. Average
0-20	177.1%	67.2%	53.5%	59.5%	66.0%
21-50	6.5	12.0	11.2	11.6	11.2
51-100	−17.4	5.2	5.5	6.3	4.3
101-500	−33.3	3.1	9.4	9.3	5.2
501+	−32.9	12.4	20.4	13.3	13.3
Total	100.0%	100.0%	100.0%	100.0%	100.0%

[1] Source: M.I.T. Program on Neighborhood and Regional Change.

tions abroad. Whatever they are doing, however, *large firms are no longer the major providers of new jobs for Americans.*

Another distinguishing characteristic of job replacers is their youth. About 80 percent of the replacement jobs are created by establishments four years old or younger (see Table IV). Not all small businesses are job creators. The job creators are the relatively few younger ones that start up and expand rapidly in their youth, outgrowing the "small" designation in the process.

Job creators are also quite volatile. The road to future growth is a tortuous one indeed. We had thought that a firm grows and develops much like a human being: It starts small, grows smoothly and rapidly during a "growth phase," matures and stabilizes for some period, and eventually becomes out-dated and falls off. Our research now suggests quite a different process. Dynamic, job creating establishments appear to oscillate, or pulsate, constantly. Periods of expansion are the best predictors of future decline, and declining periods are the foundation upon which future business growth is based.

TABLE IV. *Percentage of Replacement Jobs Created Between 1974 and 1976 by Age of Establishment and Region* [1]

Age of Business	Percent of Replacement Jobs Created			
	Northeast	North Central	South	West
0-4	75.5%	80.8%	80.4%	80.9%
5-8	10.4	8.4	9.9	8.8
9-12	7.5	6.0	5.1	5.5
13+	6.6	4.8	4.6	4.8
Total	100.0%	100.0%	100.0%	100.0%

[1] Source: M.I.T. Program on Neighborhood and Regional Change.

TABLE V. *Performance of Establishments based on Their History of Growth*[1]

1969-1972 History	Percent in 1974-1976 with: Rapid Growth	Rapid Loss	Death
Rapid Growth[2]	11.1%	16.5%	4.3%
Small Change	9.4	7.6	24.6
Rapid Loss[2]	21.9	8.0	12.6

[1] Source: M.I.T. Program on Neighborhood and Regional Change.
[2] Greater than 50% change.

Stable firms, those that have somehow isolated themselves from the ups and downs in the world around them, are the most likely to fail in the end. A sample of 1.4 million establishments that existed throughout the 1969-76 period shows that establishments that grew sharply in the past are the most likely to decline in the future, that recently declining establishments are the ones most likely to grow in the future, and that stable firms are far and away the most likely to go under (Table V). These oscillations from one year to the next are much greater than the average growth or decline that one would expect from a "life-cycle" model of corporate change. Those firms that insulate themselves from fluctuation appear to have cut off the very vitality that keeps their counterparts going. Just as failure appears essential to our system, so does instability.

Recent job replacers overwhelmingly tend to be providers of services—broadly defined to include all those private activities outside of the so-called "goods-producing" sector (manufacturing, agriculture, mining, and construction). During the period we studied, manufacturing firms in our sample actually lost jobs on balance, this small loss being offset by substantial gains elsewhere. The older, more northern, and more urban the area, the more this was true. Manufacturing picked up slightly nationwide during the latter part of the decade, but by the time the 1970-1980 U.S. figures were in, manufacturers as a group had created only 5 percent of the net new jobs in the 1970's and the goods producers as a whole accounted for only 11 percent. The other 89 percent were in services of one kind or another. Just as we moved in the 1820's and 1830's from being a basically agricultural society to being an industrial one, so now are we rapidly abandoning our heavy industrial base in favor of jobs that demand greater use of our minds and less use of our muscles and dexterity.[1]

[1] There are bright spots within the sluggish manufacturing sector including very small manufacturers and high-technology, high "thought-content" firms. The bright spots are not bright enough, however, to significantly offset the general malaise elsewhere.

These basic shifts in the nature of job replacement are not unique to the U.S., although we tend to be further advanced along this path than other nations. Nor are the findings unique to our data set or approach. Others, here and abroad, using different ways of measuring the behavior of individual firms, are finding much the same thing.

The transformation is thus a fundamental and far reaching one. We are moving from manufacturing to services, from hardware to "thoughtware," from large-scale capital-intensive companies to smaller-scale labor-intensive companies, and from a dependence on physical capital to a dependence on human capital. These shifts have been facilitated by the increasingly international nature of our economy. We no longer have to make what we consume. Instead, we increasingly create and market products that we let others assemble for us. As a result, our exports and imports have risen from 7 percent of GNP in 1950 to 15 percent in 1979, and our private assets abroad have increased from $19 billion to $377 billion over roughly the same interval.

Intervene or improve the climate?

Those who would try to influence our economic system during this sometimes difficult period of transition are faced with some very thorny problems. At the heart of the matter is the age-old problem of choosing between a direct interventionist policy or an indirect improve-the-climate policy.

Those advocating a direct policy would have us provide assistance to individual companies or industries through government actions of some sort—loans, loan guarantees, contracts, grants, import restrictions, etc. Going the climate-improvement route involves changing the general tax and regulating environments in ways that entrepreneurial business people find attractive, thus letting the market determine who flourishes and who does not.

A direct policy is, and always has been, a "natural" for governments. It gives them a feeling of accomplishment—a series of deals (and jobs created) that they can point to with pride. Thus, it is not surprising to find that we have a broad array of such programs spanning several administrative branches of government, from the federal to the state and local levels.

In view of our findings on job creation and shifts in the economy generally, it appears that a direct intervention will become increasingly difficult (and frustrating) to administer. How, for instance, is

an official at any level of government going to decide whom to aid? In the past, the most natural choice has been the large, stable, well-known companies because they could easily be identified (their well-financed lobbyists made sure of that) and because their risk of failing in the short-term was minimal.

But these are the companies that are the least likely to create jobs. And assisting them has a long history of not working. The Dutch and British, who have gone much farther down this road than we, have had many failures and very few successes. Our own experience, while far less extensive, is not too encouraging either. Propping up large-scale, noncompetitive private bureaucracies seems to subsidize incompetence rather than cure it.

If these same interventionists choose to redirect their efforts toward the smaller end of the scale, their problems are no less severe. How will they pick the one out of 100 or 300 small firms that will become a major job creator? How will they absorb the enormously high transactions cost associated with making thousands (or hundreds of thousands) of small-scale interventions? How will they endure the embarrassment and threat of scandal associated with a project failure rate of 30, 40, or 50 percent? These problems are not unique to government agencies. They explain in great measure why banks, insurance companies, pension funds, and university endowments are equally hesitant to become involved in small-business affairs, and why some very high percentage (in the range of 80 to 90 percent) of all startup and expansion capital for smaller businesses comes from immediate, personal sources: personal savings, friends, and relatives.

Furthermore, smaller businesses apparently do not want direct assistance. Not a single recommendation coming out of the recent White House Conference on Small Business asks that government programs or regulations be increased. The practically universal cry of owners of small businesses is that governments establish a more favorable climate and let entrepreneurs run their businesses as only they know how.

This cry, and others like it, have led many in Washington to consider seriously the value of a predominantly "climate" policy. Its purpose would be to create an environment in which innovative, job-creating firms flourish. Since smaller businesses appear to be playing an increasingly important role in the economy, special attention is being paid to their concept of a good economic environment. Following their recommendations to the White House Commission on Small Business, the list of improvements would include:

(1) lower personal taxes on capital gains, (2) lower estate taxes (so companies may be kept within a family), (3) a slower rise to the full corporate tax rate (to compensate for the unintended progression into higher brackets caused by inflation), (4) fewer and simpler regulations, (5) simpler depreciation rules, and (6) equal opportunity for smaller business in goverment procurements.

We should not infer from the recent interest in climate policies that they are universally embraced by governors and mayors. For one thing, there would be a relatively small role for these elected and appointed officials to play in the management of our economy. There are also definite problems associated with depending entirely on smaller businesses to create jobs. They have little capacity for example, for conceiving, developing, and marketing the kinds of products and services that can only be provided on a large scale—jet aircraft, large-scale integrated circuits, space shuttles, communications satellites, telephone service, etc. Smaller businesses seem to function much better as subcontractors to larger companies in these situations, relying on the larger company for the design and international marketing aspects of the job.

The reindustrialist illusion

The choice between direct intervention and climate policies will ultimately depend on what we wish to accomplish. An increased emphasis on business climate will more than likely accelerate the trend toward the dominance of smaller service-sector firms as the sources of new jobs in our economy, an increasing dependence on foreign countries for manufactured goods, and an increasing dependence on investments in human capital rather than physical capital, with all the attendant declines in measured productivity that would entail.

There are some who find this natural trend threatening. Pointing frequently to the Japanese and their increasing dominance of what used to be many of our markets, they advocate that we "reindustrialize"—that is, go back to investing more in plants that will make things more efficiently so we can meet foreign competition in markets we are now losing. Since our private sector companies do not seem to be doing this on their own, the argument goes, some form of intervention is called for.

There are several problems associated with this attempt to roll back the clock. First, it is not clear what "universal solvent" we dip our noncompetitive industries into so that they suddenly become

creative again, invest in new technologies, and work harder. Protective tariffs and import restrictions will certainly not accomplish it. Forced savings by households and businesses to finance needed physical capital (a common practice in Japan) is certainly not part of our culture.

Secondly, it is not clear that we *should* devote a tremendous effort to find a universal solvent. In our almost compulsive fascination with the Japanese and the effectiveness with which they have competed in certain markets (automobiles, electronics, watches, etc.) we lose sight of our competence in producing the "thoughtware" upon which so much of the Japanese hardware is based. It is not an accident that of the 176 Nobel science prizes awarded since 1950, the United States has received 93, the European community another 68, and Japan only two. We dominate the thoughtware field just as others are coming to dominate hardware production. And the emphasis in many fields is shifting from hardware to thoughtware. It was not uncommon five years ago for 90 percent of the cost of a computer installation to be in hardware, and only 10 percent in thoughtware (software, as the computer industry calls it). Five or ten years from now, it will not be unusual for those percentages to be reversed—80 or 90 percent software and only 10 or 20 percent hardware. For many of the same reasons, *Robotics Age* (one of the journals of the blossoming robot industry) recently changed its name to *Robotics Age: The Journal of Intelligent Machines,* saying: "... the character of the industrial robot market is rapidly moving towards increased intelligence in the controller. As this happens, the nature of the problems, both in design and application, is quickly changing from hardware to software."

What it comes down to, then, is this: Do we want to try to beat the Japanese (and others like them) at their game or play our own game instead? The evidence we have collected suggests that: (1) the odds of our beating them at their game are slim, and (2) that we are doing quite well at our own game if we can recognize it for what it is. We have spawned an extraordinary number of idea factories—in universities, businesses, and government—that generate a high percentage of the world's original ideas and that now provide employment for a greater percentage of our work force than ever before in history. In the absence of a major international conflict, this division of labor between ourselves and those who choose to make things is not necessarily bad and could well, given present trends, turn out very much in our favor.

We pay a price during a transformation of this sort. The relatively

few workers who still make things in factories[2] must adjust to different kinds of employment. Our enormous mobility gives us an advantage over other nations whose people are less mobile. But we are still left with older, skilled craftsmen for whom moving and retraining does not come easily.

Also, in the unfortunate circumstance that we enter another world war, our dependence upon others for manufactured goods could turn out to be a major liability. It already is. Every time imports rise as a percent of our GNP, our dependence increases. Furthermore, to the extent that our dependence is concentrated in selected areas (transportation equipment, electronics, computers, steel, petroleum) the effect could be even more crippling. We have experienced it recently in oil; the Russians are now feeling it in food.

National security is a major, compelling argument for stemming the present tide. It is a strong argument, and is not easily dealt with. Patriotism alone will not make our automobile plants or our steel plants or our computer plants more competitive. Nor are trade barriers and protection likely to lead to the superior technology we would need to succeed in the very conflict we are hedging against. In short, we still seem to lack the "solvent" to transform our noncompetitive industries in peacetime even if we decided, as a national policy, that it was important to do so.

Thus develops a more interdependent collection of nations in which we play a specialized role. Luckily ours is one of the more interesting and promising parts in the play. And we seem, without strong supporting policies, to be developing a mix of larger and aggressive smaller businesses to play our role well. Perhaps we should spend less time worrying about what the Japanese do better, and worry instead about how to do better what we do best.

[2] About 13 percent of the workforce is still engaged in actual manufacturing operations, as distinguished from those who manage or sell or account for the goods made by the others in firms labeled "manufacturing."

NASBIC

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April 7, 1982

The Honorable Henry J. Nowak, Chairman
Subcommittee on Tax, Access to Equity Capital
and Business Opportunities
1514 Longworth House Office Building
Washington, D.C. 20515

Dear Chairman Nowak:

During the March 24, 1982 Hearing on H.R. 5302 you indicated the record would be held open for a reasonable period of time to afford NASBIC an opportunity to comment on SBA's position on the proposed legislation.

Our comments on the various objections raised by SBA are enclosed in the form of a point-by-point analysis. These comments were delayed because a transcript of the Hearing was not available until April 6, 1982.

By working with your good offices, we feel confident that any necessary and appropriate modification can be made in H.R. 5302 so that legislation can be promulgated which is generally acceptable to the Committee, the SBA and the SBIC industry.

Sincerely,

Walter B. Stults
President

Peter F. McNeish
Executive Vice President

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NASBIC COMMENTS ON SBA's POSITION
ON H.R. 5302

A. Removing the $35 Million Ceiling on Leverage (Section 2 of H.R. 5302).

In its prepared statement SBA stated several objections to this provision:

1. SBA - The Agency questioned its need, saying only one SBIC is likely to use the new authority at the present time.

NASBIC COMMENT - First, SBA's position is both wrong and misses the point. In fact, there are presently fifteen (15) SBICs and one (1) MESBIC with private capital of $9 million or more who could take advantage of this provision on a 4:1 leverage basis (see attached list). In addition the current arbitrary ceiling is a major deterrent to these sixteen companies (and many others capitalized in the range of $5-10 million) from further increasing their capital base. The current ceiling limitation also acts as a substantial disincentive to corporate and other sophisticated investor groups who would be interested in forming a major SBIC, but are not interested at the scale dictated by the current ceiling. It also acts as a deterrent to an SBIC which would want to expand for the purpose of broadening its geographic base into areas where new opportunities for investment existed. Finally, the most negative aspect of the ceiling is the fact that it actually operates to force private capital out of the SBIC program and into areas other than small business investments. This occurs because it makes good business sense for an SBIC to "dividend out" its earnings, rather than capitalize them, when these funds lose their ability to attract leverage.

2. SBA - SBA contends removal of the ceiling would result in the formation of larger SBICs, which "could lead" to the undesirable result of available leverage being absorbed by a small number of large SBICs.

NASBIC COMMENT - SBA seems to be saying there is something inherently wrong with larger SBICs. Quite the contrary. SBA's own statistics clearly prove that larger SBICs are better performers both financially and in terms of regulatory compliance. SBA speculates that the leverage available to the industry as a whole would be monopolized by only the larger SBICs, but neglects to mention that a concentration of leverage in larger SBICs has not occurred over the programs' 23 year history. Even more important, SBA failed to acknowledge (in its written testimony) that it has the authority to allocate leverage when it is in short supply and can administratively prevent any undesirable concentration, if that ever became necessary. It did acknowledge this fact during questioning by Chairman Nowak.

3. SBA - SBA then makes the further argument that these few "immense SBICs," which could absorb all the available leverage, would "in all likelihood "provide only large-scale financings to larger small businesses.

NASBIC COMMENT - First, as stated earlier, an increased number of larger SBICs will not absorb all the available leverage - nor would SBA allow it to happen. Consequently, the SBIC industry would retain its diversification of size, character, investment policies and types and sizes of portfolio companies. In any event, we see nothing inherently wrong with a portion of the SBIC industry making larger investments in larger small businesses, so long as these firms are qualified under the size standards established by statute and SBA regulations. SBA contends (on page 2 of its testimony) that SBICs should be restricted to small scale, low dollar volume investments. This assertion portrays a complete misunderstanding of the fact that the proper arena for SBIC investments, as compared to private venture capitalists, is determined in large part by degree of risk, not size of investment. The SBIC industry is able, because of its partnership with the Government, to step into the areas where the private venture capitalist will not tred because the risk-reward relationship is not attractive enough, regardless of the size of the small firm. As Brent Rider said in his testimony, contrary to what SBA postulates:

> "We need to encourage the development of larger professionally managed SBICs with the capacity to make a significant impact on the fast-growth sector of our small business economy. That's where the new jobs are created and the new technologies are produced. In order to reach that objective the leverage ceiling should be repealed."

4. SBA - During questioning by Mr. Marriott, one SBA witness suggested that if the ceiling was repealed and increased levels of leverage provided to SBICs, then the Government would become a "bigger participant-----tampering with" the free market process of SBIC investment decisions in a way that would be detrimental to small business.

NASBIC COMMENT - NASBIC disagrees with this conclusion and rejects it as a direct contradiction of the intent and purpose of the Small Business Investment Act of 1958. The relative amount of leverage provided to an SBIC does not, and should not have any relationship to issues of Government over-regulation or over-reaching to the detriment of the program's intended beneficiaries.

B. Recognition of Unrealized Appreciation for leverage (Section 3 of H.R. 5302).

SBA makes four arguments against this provision of the bill:

1. SBA - The Agency claims it would greatly increase SBA's risk as a creditor because there is no absolute assurance an SBIC using this provision could cope with depreciation in the value of its marketable securities.

NASBIC COMMENT - SBA fails to acknowledge that it is the SBA which exercises its credit judgement prior to granting leverage to an SBIC, and this provision does not change the Agency's authority to make those credit determinations. The statute authorizes the Agency to provide leverage on a narrowly restricted portion of unrealized appreciation, but does not mandate that leverage be provided. In addition, SBA completely ignores the creditor safeguards in the statutory formula which amply protect SBA's creditor position. First of all, only the values of a narrowly restricted class of seasoned securities, which have been traded and priced in the public securities markets, are even nominally considered under the formula. Second, any depreciation in values is then substracted out of that narrow class of nominally qualified securities. Then, as an ultimate hedge to protect SBA's creditor position from future depreciation, these values are discounted by 50% before reaching a net appreciated value figure qualified for leverage. This represents a very conservative approach to recognition of unrealized appreciation and provides substantive safeguards to SBA's creditor position. It should also be noted that SBA has developed a set of proposed regulations which recognize unrealized appreciation under the same formula as that contained in H.R. 5302.

2. SBA - The Agency argues that there is no recognition of an offset for unrealized depreciation of "unmarketable" securities, and this could lead to the unrealistic leveraging of under capitalized SBICs.

NASBIC COMMENT - This is a specious argument. As a part of its normal credit review when considering a leverage request SBA always takes into account any depreciation of values in the SBIC's portfolio, whether marketable or unmarketable. Nothing in the proposed legislation even suggests the SBA should not continue to undertake the same level of creditor scrutiny of an SBIC's financial condition. If SBA provides leverage to an undercapitalized SBIC, it would be because of poor credit analysis by the SBA, not H.R. 5302.

3. SBA - The Agency contends that this provision would

result in SBIC's retaining "winners" simply to insure the availability of leverage.

NASBIC COMMENT - Clearly, SBA doesn't understand the economics of the industry or the unrealized appreciation section of H.R. 5302. First of all, it doesn't make economic sense for an SBIC to sit on appreciated marketable securities for the sole purpose of securing leverage. The fastest growth in appreciation of a small firm occurs before a company goes public, so the incentive is for the SBIC to sell, if possible, not to sit on its winners. In addition, since H.R. 5302's formula provides leverage on only 50% of the net appreciated value of its securities, an SBIC could more than double its leverage base by "cashing in" on its winners and capitalizing the full appreciation in value. It just doesn't make good business sense for an SBIC to sit on its winners for leverage considerations.

4. SBA - Finally, SBA states a "fear" that this provision will promote investment in publicly held firms rather than privately-held small businesses.

NASBIC COMMENT - As noted above, the fastest growth in appreciation of a small business occurs prior to the company going public, so it does not make sense for SBICs to invest in public companies solely for appreciation relating to SBA leverage. In addition, under SBA regulation, SBICs can invest in public securities in only the most limited circumstances. Finally, we are certain no SBIC would design its investment policy solely on the basis of marginal opportunities for appreciation in new issues of publicly held companies, particularly where only 50% of any appreciated value, netted against depreciation in all other marketable securities in its portfolio, is recognized for leverage purposes.

C. Idle Funds Investments (Section 4 of H.R. 5302).

SBA did not oppose this expanded authority, but did suggest certain "adjustments" to it.

1. SBA - The Agency states that investments in certificates of deposit should be limited to federal insurance maximums.

NASBIC COMMENT - We're perplexed by SBA's position. H.R. 5302 retains the existing statutory language from the Small Business Investment Act of 1958 with regard to SBIC investments in insured certificates of deposit (CDs). Investments in CDs above $100,000 have not been an issue with the SBA, and we have no idea why SBA would want to introduce such a regressive change now. Their proposal is, in fact, a throwback to the old system and would require that an SBIC secure multiple CDs at a host of different financial institutions. We believe this proposal is unnecessary, unwarranted and totally unrelated to H.R. 5302.

2. SBA - The Agency also suggests that qualified repurchase agreements (Repos) should be restricted to only those secured by direct obligation of the U.S. Treasury.

NASBIC COMMENT - We see no reason for SBA's restrictive suggestion. H.R. 5302 provides that repos are qualified investments if "secured by U.S. Government securities." So long as these securities are backed by the full faith and credit of the Federal Government, we see no reason why that backing should be restricted to any single Federal agency, Treasury or otherwise. In fact such a restriction simply imposes unnecessary rigidity in the range of fully-secured cash management options which would otherwise be available to SBICs.

D. Elimination of Dual Regulations (Section 5 of H.R. 5302).

SBA - The Agency opposes this section of H.R. 5302 because of a fear that its regulatory and creditor position would be compromised "if we depend only on enforcement of the 1940 Act."

NASBIC COMMENT- SBA's position represents a contradiction to a concept embodied in its own regulations which grant jurisdiction to SEC's regulatory coverage of conflict-of-interest transactions involving SBICs which are now 1940 Act companies. Section 107.1004(g) of SBA's regulations provides, in part, that:

> "A 1940 Act Company which has been granted an exemption by the Securities and Exchange Commission with regard to a (conflict-of-interest) transaction shall be exempt therefrom....."

This approach to the elimination of dual regulations has worked smoothly for a number of years without detriment to SBA's credit or regulatory position. We see no reason why SEC's jurisdiction should not also apply to SBICs which are Business Development Companies under the Small Business Investment Incentive Act of 1980.

E. Incentive Stock Option Loans to Employees (Section 6 of H.R. 5302).

SBA objects to this provision on several grounds:

1. SBA - The Agency states that it is not necessary because its purpose can be accomplished by using standard stock option plans.

NASBIC COMMENT - SBA's position overlooks the real business world. The whole point of this provision is to establish a mechanism through which SBICs can help their employees exercise standard stock option plans. The existence of a stock option plan is of no value to an employee if he does not have the financial resources to exercise his options and buy the stock. Today, most modern corporations have a companion loan program which gives those key employees the opportunity to exercise their options and buy the stock. Without such lending authority SBIC stock options are virtually worthless to their key employees.

2. SBA - SBA also argues this provision would divert funds which were intended to be invested in small firms.

NASBIC COMMENT - SBA's position is penny-wise but pound-foolish. The amount of funds "diverted" would be relatively nominal and they would be in the form of loans which would be available for investment in small firms when repaid to the SBIC. The larger question by far concerns how to retain the best professional talent in the SBIC industry. This provision makes available one small incentive to achieve that objective.

3. SBA - SBA says that it fears this provision would be difficult to administer and the regulations would be "exceedingly complex."

NASBIC COMMENT - SBA's concern on this point is addressed by H.R. 5302, which provides that SBA should promulgate rules similar to those of the SEC on the same subject. The SEC has not found these rules too complex; we see no reason why SBA should.

SBICs and MESBICs with private capital of $9.0 million or more

SBICs	Private Cap.
1. First SBIC of California	$12.5
2. Merrill Picard I	11.2
3. Small Business Enterprises Co.	12.5
4. Continental Illinois Venture Corp.	25.0
5. First Capital Corp. of Chicago	20.0
6. Northwest Growth Fund, Inc.	10.0
7. Chase Manhattan Capital Corp.	24.8
8. Citicorp Venture Capital Ltd.	37.0
9. Franklin Corp.	9.2
10. International Film Investors, L.P.	10.2
11. Midland Venture Capital Ltd.	15.0
12. Narragansett Capital Corp.	20.0
13. Energy Capital Corp.	11.3
14. Interfirst Venture Corp.	12.5
15. Mercantile Dallas Corp.	11.5
MESBICs	
1. Equico Capital Corp.	10.0

Mr. NOWAK. Mr. Ross.

TESTIMONY OF DONALD A. ROSS, PRESIDENT, RAND CAPITAL CORP., BUFFALO, N.Y.

Mr. Ross. Thank you very much, Mr. Congressman. My name is Donald A. Ross, and I am a prominent local taxpayer from Buffalo, N.Y.

I also serve as president of Rand Capital Corp., a closed end public investment company with a wholly owned SBIC subsidiary which at the close of business December 31, 1981, had an asset value of $8 million.

We were formed in 1969 with initial capital of $1¾ million. In 1971, we had an initial public offering for a similar amount. In 1976, we took $500,000 of our uninvested funds and formed our wholly owned SBIC subsidiary, Rand SBIC.

Last year we sold another 200,000 shares of our stock and raised approximately $2 million more. Our very first investment, in the fall of 1969, was a $250,000 loan to a startup cable TV system which now services virtually all the contiguous suburbs of Buffalo. At that time, we purchased an 11-percent interest in this company for $13,500. Last year we sold that stock for $6 million and had our loan paid.

This was our first big winner, and it is interesting to note that it took 12 years for it to happen. You probably have heard the axiom about venture capital that, "Lemons ripen quickly; pearls take a long time to cultivate."

I might also add that with respect to this cable TV system, it didn't all just happen easily. Along the way we were responsible for a complete change of management and three major financial reorganizations.

When we got involved with this company, there were fewer than 15 employees. Today, Comax Telcom employs 150 people in an area with 12½ percent unemployment.

One of the more interesting developments in the heart of the city of Buffalo is known as the Elm-Oak Corridor. This strip of land which was characterized by the Buffalo Evening News as a "wasteland of demolished tenements" is slowly turning into a high technology park. The first business to locate in downtown Buffalo was Nanodata Corp., a computer manufacturer.

Rand Capital invested in this firm in 1971 when it had three employees. In February of this year, it had 139 employees and occupied three floors of an 80,000 square foot renovated building at the foot of the Elm-Oak Corridor.

The financing package for this company was extremely complicated. It includes an SBA-guaranteed bank loan, a Department of Commerce-EDA loan, and the State of New York even helped out by taking title to the building and making it available to Nanodata on very favorable terms.

Once this company was up and running, a second high tech firm known as Comptek built a 55,000 square foot building one block north of the Nanodata site. The new building is called High Technology Center. With sales of $7 million during the year ending

March 1978, its sales have tripled to $22 million for the year just ended.

Comptek was founded in 1968. Its four founders started with a $500,000 equity investment from M. & T. Capital, another Buffalo based SBIC, and an SBA-guaranteed bank loan of $300,000. Needless to say, that loan has been repaid. Comptek today has 500 employees in an area with 12½ percent unemployment.

One final example of SBA and SBIC involvement with our community is Astronics Corp., with sales last year of $10 million and profits of $700,000. The company was started by a black man with lots of dreams. He worked at Cornell Aeronautical Laboratory in Buffalo. Rand Capital became involved in 1970 after he had already obtained SBA-guaranteed bank loans. Rand hired two Harvard MBA's who took his electroluminescent technology, gave it a business overlay, and brought order out of chaos. While they were doing this, we made the payrolls, loaned money as needed for working capital, and arranged for a small underwriting in 1972 which paid off all debts.

The company since that time has experienced an annual growth rate in sales and profit of 20 percent, and currently employs 209 people in an area with 12½ percent unemployment. It may be of interest that in 1977, we gave each owner of two shares of Rand Capital stock, one share of Astronics stock as a dividend.

So much for four little success stories in the Buffalo area. Let me tell you of a struggling company. We have a $150,000 subordinated loan as part of a $750,000 package to a small furniture company in Jamestown, N.Y., about 60 miles south of Buffalo. It can trace its history back 175 years.

They employ 150 people, some of whom have been with the company 40 years. It is a highly leveraged situation with bank debt in excess of $1 million. Last year at 2½ percent over prime, they were paying better than 20 percent for money for most of the year. The company experienced a loss of $100,000 after paying an interest bill of nearly $450,000.

For this company, interest is a double whammy. Without a housing industry, because of high interest, their sales have dropped precipitously; at the same time their balance sheet is being eaten alive by high interest. The employees are on a 4-day workweek; management is all drawing half salaries, and everyone is wondering how long they are going to be able to last.

I should also tell you that in all these situations, my management team at Rand becomes totally available as part-time management.

As a governor of the National Association of Small Business Investment Companies, and having spent 14 years in this industry, I can also tell you that it is quite common for venture capitalists to join with management of their investments in solving problems and making the day-to-day decisions that are so critical to survival during times of crisis.

All of us have developed considerable skills helping to make sick investments healthy. I can't think of a better way for the Government to maximize job creation than by putting its money on the table with ours through the medium of the SBIC program.

Most of the investments we make require long incubation periods before they can be ruled successful, and some never succeed, but the fact remains that all businesses, even the giants such as IBM, United States Steel and A.T. & T. were all once small businesses. Technologies that have revolutionized modern day living can take a long time to develop.

Carlson spent 20 years perfecting xerography, and Leopold Godowsky, who serves on the board of one of our investments, has told me it took him 17 years to perfect the kodachrome process for Kodak. So, quite literally, some of the new ventures that we invest in require long-term assistance, and, in turn, we need the long-term support of the SBIC program in repaying our loans.

Since NASBIC has discussed the technical provisions of this bill, H.R. 5302, and since they have done such a complete job, I will not take the time to repeat the discussion but will go on record as heartily endorsing this bill. Thank you Congressman Nowak and Congressman Marriott for your sincere interest in the SBIC industry and for introducing this bill. Thank you from the citizens of Buffalo, N.Y.

Mr. NOWAK. Thank you, Mr. Ross, especially for pinpointing what broader aspects have been accomplished within a very limited area in the city of Buffalo, the opportunities, including job creation, that were provided and the impacts, and the ripple effects of your initial investments, and also the M. & T. investment will have on the city and the employment base. Let me ask a couple of general questions and we can go back and forth here between the witnesses. I think the first problem that we're looking at, of course, is to try to get the ceiling for leveraging the amount of dollars available through the appropriation process.

I'm wondering if you could discuss with us from your perspective what the impacts of the administration's $125 million ceiling would have on this total program for the foreseeable future, if we were limited to that kind of level?

Mr. RIDER. Well, Mr. Chairman, it seems to me, as we said in our testimony, that there is obviously a disincentive to have more than $11.7 million in capital in an SBIC because there is no further leverage advantage. The SBA has testified that there is only one company that is likely to ask for that leverage at this point. I would say that if that's the case, then perhaps they shouldn't be nearly so worried.

But I think the fact is that the more funds that get into the SBIC's, wherever they are, the more things we can do to make the SBIC a more attractive vehicle, and the more likely it is that substantial amounts of funds are going to be put into the small businesses. I think that's what we're all here for.

Mr. NOWAK. Mr. Stults, do you have a comment on that?

Mr. STULTS. Typically, Mr. Chairman——

Mr. NOWAK. The kinds of demands that may be forthcoming?

Mr. STULTS. I think that if the industry felt that it had to look forward to allocations of leverage, and that leverage would not be available in sufficient amounts to meet the needs of the SBIC's and the small business community, you would find that this would become a stagnating and a declining industry.

As a matter of fact, in the early days of the program—I can recall during about a 5-year period in the early midsixties—when Congress did not provide enough leverage for SBIC's. At that time, the amount of private capital coming into the industry declined precipitously. The number of deals we did each year declined precipitously.

I think NASBIC recognizes and is willing to make its share of the sacrifice during 1980, 1981, 1982 Reagan budget cuts, but we do want to be able to see some kind of light out there so that our active companies will, indeed, continue to make loans and investments of the type that Congress wants us to make to new and growing businesses.

The $250 million decision made by this committee 10 days ago was probably the high point of the best positive sign that we have had in the last year. As opposed to what SBA said, indeed, fiscal 1981 SBIC's wanted more money than SBA provided; $160 million was authorized. We actually drew down $158.6 million, but that was strictly arithmetical.

SBIC's were under allocations; a number of SBIC's were told they could not apply for all the funds they wanted in fiscal 1981. We figure that in fiscal 1982, there will be at least $100 million of unmet demand on the part of SBIC's.

Mr. Ross. Congressman Nowak, I just want to add one comment to these two remarks.

I've heard the slogan that crime wouldn't pay if the Government ran it. I don't know that I necessarily subscribe to that. However, I think that in the past few years we've seen some Government involvement in the lending business that borders on the ludicrous. There was a $50 million loan to Wisconsin Steel by another agency of the Government where that company went bankrupt a few weeks after they received the funds. That's a third of the entire SBA budget. A similar amount up in Boston to Sea Train Lines or some similar name also failed within 1 year.

Government employees lending money tarnished that Department's loan program and probably rubbed off on the SBA. People perceive the Government lending or spending money and, of course, the whole business of Government lending or spending money is why most of us feel that we have high interest rates. So there is an effort now to get the Government out of the lending business, and I'm not sure that I'm opposed to that.

But I would like to say this: In the private sector when you make bad loans in an SBIC or for that matter, in a bank, you pay the piper. There doesn't seem to be too much recourse to the people who lend money in Government other than we, the taxpayers have to continue to pay for it.

So I suggest to you again as I said in my earlier remarks that having you people put your money on the table with ours is responsible. I think you maximize the use of Government dollars. Lord knows the amount that you put into this SBIC program is incredible small in comparison to some of the other grandiose things that go on in the U.S. Government today. It's virtually nothing.

Mr. NOWAK. Thank you very much. I think we reflected that when the SBA administrators were here in trying to encourage them to try to make those points very strongly to the Office of

Management and Budget. There is a management aspect of this that is absent in many of the other programs, and yet the dollars that were recommended by the administration would seem to group all of the programs together without looking at what specifically is happening with this program.

One of the other aspects of this—and I hope we can touch on it at this point—is the personal interest, or the involvement, that coincides with what you've just said, management involvement to the degree that you're actively engaged once a loan or a position is taken in a company. I wondered if you could, for the record, go through what kind of assistance you do provide.

Mr. Ross. Since I addressed that in my earlier remarks, let me make a few more comments. We find in reviewing the portfolio at Rand Capital that those things that have been most successful have been those investments we've made closest to Rand or in the city of Buffalo. In analyzing that, we find that we've been successful because when they're a few blocks or a few miles away, we can get involved directly quite apart from writing a check. In the most successful of all our investments, the cable system, we had to go in and throw out the whole management team and rearrange financing three times. We did it because the company was literally 5 miles from our offices.

If it had been in Texarkana, we probably would have been totally incapable of doing anything or even have been aware of the seriousness of the management problems until it was too late to do anything.

So I say that many of the other SBIC's perform these same functions that we have done and even better than we do. In other words, we get in and mix it up with the management, change and reposition them, do all the things that are necessary to make a company successful.

Mr. NOWAK. Mr. Rider, would you like to make a comment?

Mr. RIDER. I agree. I think one of the other things that we do that Don only touched on is actually to raise money for these companies from other sources, not just from other SBIC's.

I think we are creative in that regard. Most of the managements of most of the companies that we invest in not only need our assistance but, in fact, appreciate it very much. I, personally, for example, at this point spend 3 days a week on one company which is prospering mightily, I might say, but we usually spend that much time when the company gets in trouble, I suppose.

But in this case, we have one that is doing very well and it's because everyone in the investment group is spending a lot of time helping that company.

Mr. NOWAK. You had mentioned in your testimony the job creation feature and the cost of a job if you averaged it out. I wonder if your industry could provide this subcommittee any data on the job creation that has transpired as a result of the program.

Mr. RIDER. Yes; I have the statistics at this point. I think we should just submit them for the record. It's a simple mathematical division of the total cost of the program which is $46,100,000 according to Deloitte, Haskins and Sells, and we have created 147,730 jobs. Dividing the number of jobs and the cost comes up with a number of about $312.

Mr. NOWAK. Per job. Thank you. We will accept that in the record, and before I turn the questions to Mr. Marriott, the suggested amendment to section 4(b) that you mentioned in your testimony, would that necessitate a position in SBA in your opinion?

Mr. STULTS. No, sir, they've got a whole flock of the Associate Administrators down there, and they have in the past, as recently as 20 months ago, had an Associate Administrator for Investment and an Associate Administrator for Finance. Mr. Cardenas did consolidate those two posts.

Mr. NOWAK. Thank you very much. Mr. Marriott?

Mr. MARRIOTT. Thank you. I appreciated the testimony, and I endorse what you say 100 percent, and I congratulate you all on the good work that you do with those SBIC's.

Let me ask you two questions: SBA is worried about its lifting the ceiling to an unlimited number. Could you live with some compromise there, say, $55 million or some such? In other words, take the ceiling up gradually, rather than just lift it?

Mr. RIDER. A half a loaf is hard to negotiate. A half a loaf is not always enough, I suppose, but certainly, any increase would be better than none at all.

Mr. MARRIOTT. Is it realistic to expect that even if we lifted the ceiling completely we would ever get up and have that many companies at that level? I'm just wondering if we're talking about things that are of very little consequence here in the long run.

Mr. ROSS. I don't think we're talking about things that have little or no consequence. By virtue of having this limit so long, we have precluded some very substantial entities from going into the program.

What you can put into the SBIC under the leverage formula is $11 million. For Texaco or some of these huge corporations that wanted to play the venture game, a corporation such as Allstate Insurance, Continental Illinois National Bank, J. H. Whitney—they are big players that want to enter the venture game, but they do it directly with their own funds. They do not form SBIC's because it's too rinky-dink for them at an $11 million level.

Mr. MARRIOTT. Let me come back to the SBA's concern now. I want to get your opinion on that. Now, with all these new big players, will that squeeze out the little players? Or, is there still a place in the SBIC business for the guy who goes out and raises half a million dollars and leverages it 3 or 4 to 1? That's not big business and might be of questionable profitability, I suppose, but what about it?

Mr. RIDER. A great preponderance of NASBIC's membership—and Walter would probably have the statistics at hand—are quite small. I would say there very definitely still is a place for the small person in this industry, but it seems to me we must remember that we are not granting that additional leverage to any particular company. We are simply giving the authority to SBA to do so if, in its judgment, that would be the best use of its funds. So the ball is still in their court.

Mr. MARRIOTT. But that doesn't answer my question directly. We on this committee, have voted to authorize $250 million for the SBIC program. If you lift the ceiling, is that going to have an effect on the folks at the low end?

Mr. ROSS. I say no, and I say that again from my own experience, Congressman. In western New York where I live and function, there are four SBIC's. I mention two: My own, and we're very venturesome; we do startups, all kinds of exciting things, and we have losses. M. & T. Capital used to be that way, but now it's more conservative. They are bank owned. They're private, and they don't have to tell anybody their business, and so they don't.

But there are two more that virtually no one hears about, and they are very small. One was started by a food chain that's very successful, and it's used to finance new franchise food stores, and that's a common practice in the SBIC industry. Very worthwhile. Mom and pop can get a lot of money and a lot of help from the big professional and get their money at reasonable rates today as opposed to prime plus 2, or 24-percent interest, and they are functioning quite well. I think it is Peter Schmitt & Co.

There's a fourth that was started 2 years ago by a very bright young man who had a contracting business, and decided that wasn't where the future lay, but he had become very adept at financing heavy earth-moving equipment and so he formed an SBIC for a half million dollars to finance earth-moving equipment. He is doing this in the Niagara Falls and Buffalo area for people who can't get bank financing for earth-moving equipment.

There is room in this business for anybody who is good at it and wants to start with a half million dollars.

Mr. RIDER. Mr. Marriott, I have probably on the average two or three individuals a week coming to my office or telephoning me with very strong interest investing $½ or $1 million, perhaps in a partnership with other people or whatever, in an SBIC.

I believe that those people are correct in assuming that they can do well in this business. I think that there would be no crowding out. The fact that there is more money; in my 14 years in this business, I have never seen too much money in the venture capital business.

There is always a greater demand than there is a supply. It seems to me that the best thing for the small business would be to provide more money in some reasonable fashion to him, and I don't see where that would, in any way, cause a crowding out of the small company.

Mr. MARRIOTT. I'm not sure you've answered my question. I agree with what you've said, but the question is this: If we authorize $250 million, and that's the limit, and we've allowed the bigger boys to expand by lifting the ceiling, the money is going to go faster. So when the new guy comes in, there is no money. I think that's the issue that SBA is worried about, and I suppose some of the smaller businessmen are concerned about. How do you address that issue?

Mr. STULTS. I suppose the reason you haven't gotten an all-out answer is that it is obvious on its face that if SBA were to let an $80 million SBIC drawdown $250 million in leverage next year, there would be no leverage for any other companies. That's all she wrote because all that Congress is going to authorize is $250 million.

I think what we are trying to show you, however, is that we believe there is almost unlimited need for SBIC's out there. We think

we've got a good enough story that we can convince Capitol Hill and the executive branch that $250 million is just the beginning of the kind of support we need, and whether it is a $500,000 small SBIC or a $30 million big SBIC, there's need for this whole gamut of companies.

So we are responding by sort of ducking your question. Fiscal 1983 will be a stinker; SBA is going to have to make tough decisions. Yes, Rider, you get all you need because all you need is a half million dollars. Ross, you need $3 million. We're going to cut you down to $1 million. They're going to have to do it.

But we're hoping that that $250 million ceiling will not exist into the future. We are hoping that there will be hundreds of more SBIC's of all sizes. We hope we'll have a few in Utah, too, Mr. Marriott. We've not been very successful out there in attracting venture capital into our program.

Mr. MARRIOTT. Yes, well, the bottom line, I suppose, is when you've got a good program, go with it. What we are looking for is not only increased ceilings, but increased funding as well. I certainly agree that we ought to do that.

Mr. STULTS. Well, one specific thing. There are SBIC's with leverage now, as SBA pointed out. Only 16 of them have capital above $10 million. But if you are an SBIC and you have a big winner in your portfolio, you've got two choices. One, you can dividend it out to your shareholders. You might as well do that if all the leverage you could get is $35 million.

The other thing you can do is pay your taxes on it, put it into your capital structure, and there is that extra millions of dollars ready to go to work. Right now the law says, you're a damn fool to keep it in your company because every dollar you keep in there lessens your leverage potential; give it to the shareholder.

We'd like to be able to keep growing on our own success the way our portfolio companies do. We don't let them pay dividends; it makes sense for us not to.

Mr. MARRIOTT. I think your point is well taken. Again, I appreciate your testimony, and hope that we can get something going here that will solve our problem.

Thank you, Mr. Chairman.

Mr. NOWAK. Thank you, Mr. Marriott. I would just comment further on that last point which was one I made to the SBA. We're not mandated to create one $80 million SBIC. It's not in the law, if you're applying and receiving. They still have the full discretion to look at all the needs out there, and to try to devise a package that makes the most sense from their point of view as managers of their own portfolio.

The second point, of course, is that I would assume that in some instances, if you had a larger source of money, a larger SBIC sitting out there, that investments can be joined. If a small SBIC takes the time to look at management of the company, and the potential of the company, and if they don't have the wherewithal, perhaps some of these things could be combined, and you could take a combination of different sizes of SBIC's which I understand has happened in the past to make a company totally capital-safe, so to speak.

Mr. RIDER. In combination, Mr. Chairman, in the syndicate? Yes, that's done all the time. I suspect it will continue to be done.

Mr. NOWAK. So if we did have a couple of larger available partners out there, perhaps you could take advantage of your own association to create, for example, a capital base for a company?

Mr. RIDER. Yes, that's true. Many cases where—as Don mentioned—Nanodata with $20 million, eight partners or something?

Mr. ROSS. There were a very substantial number of partners.

Mr. NOWAK. Well, fine. Thank you very much. You know, our concern here is, and again, I repeat the statement, for the rest of the so-called guarantees which are being reduced or eliminated throughout the Government program.

As we look at the current recession, we know that there is going to be a need for terrific new capital and new investments, and unless those are going to be made available at an interest rate that makes sense to a merchant company, we're just not going to be able to take advantage of all the supply-side economics that it is alleged will move everything forward without any joinder of any other initiatives.

We appreciate your taking the time to testify, and certainly, we'll be looking forward to working with the SBA on some of the initiatives in our bill.

Mr. STULTS. Will the record remain open so that we may comment upon some of SBA's comments so that we can respond on our justifications?

Mr. NOWAK. Yes, without objection again, we will keep the record open for a period of 10 days to allow you to respond to some of their remarks. Thank you very much.

Mr. STULTS. Thank you.

Mr. NOWAK. Our next witnesses will be from the American Association of MESBIC's. We have Mr. Robert Kemp, president of Opportunity Funding Corp. and Fulcrum Venture Capital Corp. here in Washington, and he will be accompanied by JoAnn Price, vice president.

Mr. MARRIOTT. Mr. Chairman, before you go on, I have to leave in a few minutes. So, if I get up and go in the middle of your testimony, you'll know why; I have to be at another hearing.

Mr. NOWAK. Mr. Kemp is an electrical engineer by profession and holds an MBA degree from the University of California at Los Angeles. He has written extensively and is a noted lecturer at many functions throughout the country.

Mr. Kemp, it is a pleasure to have you before the committee.

TESTIMONY OF ROBERT KEMP, PRESIDENT, OPPORTUNITY FUNDING CORP., AND FULCRUM VENTURE CAPITAL CORP., WASHINGTON, D.C., ACCOMPANIED BY JOANN PRICE, VICE PRESIDENT, AMERICAN ASSOCIATION OF MESBIC'S

Mr. KEMP. Thank you, Mr. Chairman. Good morning. I am Robert Kemp, president of Opportunity Funding Corp. and Fulcrum Venture Capital Corp., both located here in Washington, D.C.

I am here today in my capacity as president of Fulcrum Venture Capital Corp., a 301(d) investment company. Accompanying me

today is Ms. JoAnn Price, vice president of the American Association of MESBIC's.

MESBIC's were created administratively in 1969, and through legislative mandate in 1971 as 301(d) SBIC's, commonly known as MESBIC's. They are specialized for profit venture capital vehicles, licensed and regulated by the Small Business Administration to provide financing and offer management assistance to a portfolio of small businesses owned by minority entrepreneurs.

MESBIC's represent a unique private-public partnership which utilizes the base of long-term private capital and the add-on leverage dollars of preferred stock and purchased debentures to expand the pool of capital available to minority-owned businesses.

By late 1980, there were approximately 129 licensed MESBIC's representing a total of over $178 million in investment. In 1980 alone, MESBIC's invested $42 million in 547 financings. In 1981, I believe the MESBIC investment figure is $55 million.

The average company invested in generated $818,000 in gross sales, and had assets of $616,000. In addition, the $42 million generated an additional $84 million in capital into small business concerns. As a result of these financings, more than $36 million in employee payroll taxes were generated with taxes paid by portfolio companies amounting to $4½ million.

These tax dollars, plus the savings realized from potential unemployment costs, bring the annual Government benefit for fiscal year 1980 to over $44 million. The private-public sector partnership of the small business investment company industry promotes the administration's goal of encouraging the small business sector at the same time it draws private capital into the program, decreasing the cost and responsibility to the Government of achieving this goal.

The subject of today's hearings is vital to the continued growth of SBIC's and MESBIC's. The regulations in their present form restrict, limit and discourage the creation and growth of large, well capitalized SBIC's and MESBIC's which ultimately limits the flow of capital to qualified small business concerns.

The reduction in the pool of investment capital resulting from the shrinking budget and the tightening of loans to small businesses from conventional sources due to high interest rates make it even more essential that we allow for, and encourage the development of substantial SBIC's and MESBIC's.

SBIC's are proven successful programs that should be allowed to increase their own capital pools. With the present leverage ceiling of $35 million, the private capital investment incentive severely diminishes after the investment company has invested approximately $9 million. It is conceivable and even probable that corporate SBIC's would be both willing and able to invest over $9 million in private capital but are reluctant to do so because of the existing ceiling.

In addition, the recognition by SBA of unrealized appreciation for leveraging purposes would increase the capital base for MESBIC's and SBIC's and help to channel more funds into qualified small business concerns. The present discretionary portfolio provisions for SBIC's limit the efficiency and profitability of their funds.

The proposed bill would allow for investments with higher yields while maintaining the requirement of investments restricted to financially safe instruments. There is little cost or risk to the Government by this provision, and the association strongly urges your support of this measure.

Section 5 of House Resolution 5302 coordinates affiliate transaction rules for SBIC's which are business development companies under the Investment Act of 1940.

This section would simply afford the same treatment to business development company SBIC's as it presently does to SBIC's registered under the Investment Company Act of 1940.

Section 6 authorizes SBIC's to make loans to their employees to buy stock options. The association endorses both of these provisions and encourages your support.

In addition to the above-mentioned proposals, the association would like to take this opportunity to comment on an issue profoundly affecting the capital base with which the industry operates.

Shortly after the MESBIC program was initiated, the SBA, in an effort to channel more funds into the newly-formed MESBIC program, approved the leveraging of public funds through a regulation stating, "A licensee may include nonprivate funds, for example, those funds granted under title 7 of the Community Services Act of 1974, as amended, in its private capital for purposes of sections 302, 303, and 306 of the Investment Act." Providing at least 10 percent of the potential leverage funds came from a private source, the SBA was leveraging public dollars invested in MESBIC's.

Thus, in addition to the public funds attracted to the industry by this regulation, private funds were being invested in MESBIC's. These funds were dependent for their effectiveness to a large extent on the leverage ability of the public funds they accompanied.

By mid-1980, over $17 million in Government funds with a complement of over $10 million in private capital had been invested in the MESBIC industry as a result of the public funds leveraging regulation. In July 1980, the Comptrolier General issued an opinion that in the absence of specific statutory provisions to the contrary, the SBA had no legal basis to leverage Federal funds invested in MESBIC's.

Furthermore, this decision was challenged and upheld in a later Comptroller General's decision of January 1981. Thus, the potential utility of over $100 million targeted to one of the administration's highest priorities, the small business sector, has been jeopardized.

The Small Business Administration's policy on the Comptroller General's decision has been both inconsistent and incoherent. The SBA has gone from accepting all public funds as qualified for leverage dollars to favoring certain programs funds over others to finally refusing to leverage any public funds whatsoever, although the Comptroller General's decision itself allows for public funds leveraging in certain cases.

Thus, the SBA has been little help to the industry on this issue, and by delaying a formal reaction, has caused the incurrence of great cost by MESBIC's with public funds. It is our opinion that if the standards by which capital can qualify for matching SBA funds

change, the regulations should reflect that change before it takes effect.

As investment companies, MESBIC's must establish long-range investment plans based on their perceptions of future economic conditions and act accordingly. Revoking a right to public funds leveraging prevents these MESBIC's from fulfilling commitments based on their original expectations and exposes them to possible legal action by the portfolio firms to whom those commitments were made.

In addition, while the SBA may not recognize Federal funds as capital to be matched, it does include such capital within the scope of idle funds to be fully invested before any new request for leveraging can be acted upon. Thus, MESBIC's are pressured to invest their Federal funds at the same time that the SBA refuses to leverage those funds.

It is our belief that AAMESBIC, the Congress and our association, AAMESBIC, that Congress intended these public funds to be leveraged as evidenced by the statutory language of the Federal Railway Act.

We would, therefore, recommend that legislation be considered such that the words "private capital" as used in the United States Code of the Small Business Investment Act of 1958 be defined and interpreted to include not only capital which has been raised from private individuals, partnerships, or corporations, but also for purposes of leveraging nonprivate or public funds such as, by means of illustration and not limitation, funds received from the Department of Housing and Urban Development, EDA, the Federal Railroad Administration of the Department of Transportation, Community Services Administration, and others. Such interpretation of private capital shall apply only to those funds invested in MESBIC's prior to the decision of the Comptroller General which was dated July 29, 1980. Such funds will retain eligibility for up to four tiers of SBA leveraging.

Further, we recommend that the Code of Federal Regulations be ratified and approved as it relates to those nonprivate or public funds invested in MESBIC's prior to the above-mentioned Comptroller General's decision.

That the Comptroller General, the GAO and the SBA shall recognize and adhere to this decision. Mr. Chairman, we thank you for this opportunity to present this testimony. I would be happy to entertain any questions you may have.

Mr. NOWAK. Fine. Thank you very much, Mr. Kemp. Your testimony will be received into the record without objection.

[The prepared statement of Mr. Kemp follows:]

PREPARED STATEMENT OF ROBERT KEMP, PRESIDENT, OPPORTUNITY FUNDING CORP. AND FULCRUM VENTURE CAPITAL CORP.

Good morning, Mr. Chairman. My name is Robert Kemp, President, Opportunity Funding Corporation and Fulcrum Venture Capital Corporation both located in Washington, D.C. Accompanying me today is JoAnn Price, Vice President, American Association of MESBICs.

Created administratively in 1969 and through legislative mandate in 1971, 301(d) SBICs, commonly known as MESBICs, are specialized for profit venture capital vehicles licensed and regulated by the Small Business Administration to provide financing and offer management guidance to a portfolio of small businesses owned by mi-

nority entrepreneurs. MESBICs represent a unique private/public sector partnership which utilizes the base of long term private capital and the add-on leverage dollars of preferred stock and debentures purchased to expand the pool of capital available to minority owned businesses.

By late 1980, there were approximately 129 licensed MESBICs representing a total of over $178.4 million in investments. In 1980 alone, MESBICs invested $42.2 million in 547 financings. The average company generated $818,000 in gross sales and had assets of $616,000. In addition, the $42.2 million generated an additional $84 million in capital into small business concerns. As a result of these financings, more than $36 million in employee payroll taxes were generated, with taxes paid by portfolio companies amounting to $4.5 million. These tax dollars, plus the savings realized from potential unemployment costs, bring the annual government benefit for fiscal year 1980 to over $44.9 million.

The private/public sector partnership of the Small Business Investment Company industry promotes the administration's goal of encouraging the small business sector at the same time it draws private capital into the program, decreasing the cost and responsibility to the government of achieving this goal.

The subject of today's hearings is vital to the continued growth of SBICs and MESBICs. The regulations in their present form restrict, limit and discourage the creation and growth of large, well capitalized SBICs and MESBICs, which ultimately limits the flow of capital to qualified small business concerns. The reduction in the pool of investment capital resulting from the shrinking budget and the tightening of loans to small businesses from conventional sources due to high interest rates, makes it even more essential that we allow for and encourage the development of substantial SBICs and MESBICs.

SBICs are proven successful programs that should be allowed to increase their own capital pools. With the present leverage ceiling of $35 million, the private capital investment incentive severely diminishes after the investment company has invested $9 million. It is conceivable and even probable that corporate SBICs would be both willing and able to invest over $9 million in private capital, but are reluctant to do so as a result of the existing ceiling. In addition, the recognition of unrealized appreciation for leveraging purposes would increase the capital base for MESBICs and SBICs and help to channel more funds into qualified small business concerns.

The present discretionary portfolio investment provisions for SBICs limit the efficiency and profitability of their funds. The proposed bill would allow for investments with higher yields while maintaining the requirement of investments restricted to financially safe instruments. There is little cost or risk to the government by this provision and the Association strongly urges your support of this measure.

Section V of H.R. 5302 coordinates affiliate transaction rules for SBIC's which are Business Development Companies under the Investment Company Act of 1940. This section would simply afford the same treatment to Business Development Company SBICs as it presently does to SBICs registered under the Investment Company Act of 1940. Section VI authorizes SBICs to make loans to their employees to buy stock options. The Association endorses both of these provisions and encourages your support.

As pointed out earlier, prohibitively high interest rates on loans from conventional sources make the Small Business Investment Company program increasingly important as a source of small business investment capital. For this reason, the Association encourages the installation of an associate administrator for investment within the Small Business Administration to oversee the investment programs and act as an internal advocate.

In addition to the above-mentioned proposals, the Association would like to take this opportunity to comment on an issue profoundly affecting the capital base with which the industry operates.

Shortly after the MESBIC program was initiated, the SBA, in an effort to channel more funds into the newly-formed MESBIC program, approved the leveraging of public funds through a regulation stating;

"A licensee may include nonprivate funds (e.g., funds granted under Title VII of the Community Services Act of 1974 as amended) in its Private Capital for purposes of sections 302(a), 303(c), and 306 of the Act. 13 C.F.R. 107.101(d)(2)(i)."

Providing at least 10% of the potential leveraged funds came from a private capital source, the SBA was leveraging public dollars invested in MESBICs. Thus, in addition to the public funds attracted to the industry by this regulation, private funds were being invested in MESBICs. These funds were dependent for their effectiveness to a large extent on the leverage-ability of the public funds they accompanied. By mid 1980, over $17 million in government funds, with a complement of over $10 mil-

lion in private capital had been invested in the MESBIC industry as a result of the public funds leveraging regulation.

In July of 1980, however, the Comptroller General issued the opinion that, in the absence of specific statutory provisions to the contrary, the SBA had no legal basis to leverage federal funds invested in MESBICs. Furthermore, this decision was challenged and upheld in a later Comptroller General's decision in January of 1981. Thus, the potential utility of over $100 million, targeted to one of this administration's highest priorities, the small business sector, has been jeopardized.

The Small Business Administration's policy on the Comptroller General's decision has been both inconsistent and incoherent. The SBA has gone from accepting all public funds as qualified for leverage dollars to favoring certain program's funds over others, to finally refusing to leverage any public funds whatsoever although the Comptroller General's decision itself allows for public funds leveraging in certain cases. Thus, the SBA has been little help to the industry on this issue and by delaying a formal reaction has incurred great costs on MESBICs with public funds.

It is our opinion that if the standards by which capital can qualify for matching SBA funds change, the regulations should reflect that change before it takes effect. As investment companies, MESBICs must establish long range investment plans based on their perceptions of future economic conditions and act accordingly. Revoking the right to public funds leveraging prevents these MESBICs from fulfilling commitments based on their original expectations and exposes them to possible legal action taken by the businesses to whom those commitments were made.

In addition, while the SBA may not recognize federal funds as capital to be matched, it does include such capital within the scope of idle funds to be fully invested before any new requests for leveraging can be acted upon. Thus, MESBICs are pressured to invest their federal funds at the same time the SBA refuses to leverage those funds.

We would therefore recommend that legislation be considered such that the words "private capital," as used in 15 U.S.C. 683(c)(2)(iii) of the Small Business Investment Act of 1958, shall be defined and interpreted to include not only capital which has been raised from private individuals, partnerships or corporations, but also, for purposes of leveraging, non-private or public funds such as, by means of illustration and not limitation, funds received from the Department of Housing and Urban Development, the Economic Development Administration, the Federal Railroad Administration of the Department of Transportation, the Community Services Administration and others. Such interpretation of private capital shall apply only to those funds invested in MESBICs prior to a decision of the Comptroller General of the United States dated July 29, 1980. Such funds will retain eligibility for up to four tiers of SBA leveraging.

Further, we recommend that 13 CFR 107.101(d) be hereby ratified and approved insofar as it relates to those non-private or public funds invested in MESBICs prior to the above-mentioned Comptroller General's decision, and that the Comptroller General of the United States, the General Accounting Office and the Small Business Administration shall recognize and adhere to this decision.

We thank you for this opportunity to testify before your committee and I would be happy to entertain any questions you may have.

Mr. NOWAK. The support for the bill is appreciated, and as far as your amendment is concerned, the proposal really based an equitable argument that certain MESBIC's would be unduly burdened by change in the SBA leveraging policy, since they've apparently already made investment decisions and commitments in relying on some of that policy. That's basically what you're looking for?

Mr. KEMP. That's correct.

Mr. NOWAK. Do you or your organization have any numbers on the amount of MESBIC's which would be affected by the proposed amendment?

Mr. KEMP. I'd like to call on Ms. Price.

Mr. NOWAK. Yes.

Ms. PRICE. There are approximately 17 MESBIC's affected by SBA's current policy.

I think there are approximately $17 million in public funds invested in the industry since the inception.

Mr. NOWAK. $17 million of other than private dollars?

Mr. KEMP. That's correct.

Mr. NOWAK. This would be Government dollars from other agencies that you've mentioned in your testimony. I wonder if you can provide us for the record—since we are talking about $17 million and a limited number of your members have obtained this already—I wonder if you could give us a breakdown of where they received the public leveraging or the public investments from so that we could get a clear picture of all the agencies affected and how this would affect your whole situation if some change is not made.

Ms. PRICE. We are currently putting it together and we will be pleased to provide it.

Mr. NOWAK. We will hold the record open for approximately 10 days. We'd appreciate it if you could get it to us by that time. I think that with that insertion, with a clear understanding of what has happened to your industry regarding this decision, we could hopefully incorporate that into anything that we finally end up with here in bill form.

[The material referred to above was not received for insertion into the hearing.]

Mr. NOWAK. I think it behooves SBA to keep a close watch on these so we don't have failures just because of this change of policy.

Mr. KEMP. That's correct.

Mr. NOWAK. Do you feel you're getting that kind of cooperation from SBA, as they're looking at these individually?

Mr. KEMP. We're getting a mixed reaction, as I pointed out earlier. The illustration is that, in the instance, for example, of the Economic Development Administration and the Department of Housing and Urban Development public funds, there is leveraging of public capital for those, including the Community Services Administration.

In contrast to that, though, the Department of Transportation in which Congress legislated it for our act, and included in it provisions for public investments in MESBIC's specifically to carry out the mission of the act, those funds are not being leveraged, and therefore, we're being treated—MESBIC's that have public funds are being treated—differently and inequitably under what should be the same rule.

Mr. NOWAK. When you submit that data, if you could put some of the substantive problems that some of those MESBIC's face because of prior commitments and show how they're locked in, and if they don't act, and this problem isn't solved, what the consequence could be: law suits or——

Mr. KEMP. We'd be happy to do that. We have situations now where commitments have been made for a second round of financing, and it is not possible to honor those commitments because of the SBA policy in the Comptroller General's opinion.

Mr. NOWAK. OK, if you'll submit that to us, I think we'll be able to see what the effects are and we'll be happy to work with it. I'm sure the chairman of the full committee and ourselves bring SBA in to see exactly the problems that are created, the possibility of failures because of this decision. When that is submitted, I'll cer-

tainly make the chairman aware of the problem and have our staff sit down with his and perhaps we can get together at that time.

Mr. KEMP. Mr. Chairman, thank you. In conjunction with the NASBIC request to respond to the SBA comments, we'd also request the record be open for response to those statements.

Mr. NOWAK. Fine, we will hold it open for 10 days, and please get all that information here as soon as you can. If you need extensions, please let us know as soon as possible. We've got to lock this up as soon as we can.

Mr. KEMP. All right, thank you very much.

Mr. NOWAK. Thank you. Our last witness is Martin Koldyke, from the National Venture Capital Association. He is the director of the association, and a partner in Frontenac Capital Corp. I understand that you would like the record open to submit some formal testimony also. We'd like to have you understand it will be open for 10 days, and I understand also that you would like to make some oral statement based upon what your finding and what's happening out there.

[The material referred to above was not received for insertion into the hearing.]

TESTIMONY OF MARTIN KOLDYKE, DIRECTOR, NATIONAL VENTURE CAPITAL ASSOCIATION, AND GENERAL PARTNER, FRONTENAC CO.

Mr. KOLDYKE. Yes, Mr. Chairman, thank you very much. You have been very patient this morning, and I'll attempt to be brief and also attempt not to duplicate the comments that Brent Rider, Mr. Stults, and Mr. Ross have made. I felt that they did an outstanding job of dealing with the more global issues facing our industry.

The National Venture Capital Association is made up of 124 members. These are private equity firms. A few of us in NVCA do have SBIC affiliates. The NVCA strongly supports the Small Business Venture Capital Act of 1981, H.R. 5302, and urges its passage. The 124 members of NVCA, together with various members of NASBIC, have been successful in recent years in sponsoring and financially backing, monitoring, and being involved in such companies as Apple Computer, Genetech, Storage Technology, Triad, Tandem Computer, NBI, Com-Serve that together comprise an honor roll of American business.

But without the activities that NVCA- and NASBIC-sponsored companies have been involved in over the last decade, the face of American business would be altogether different today.

That's why, Mr. Chairman, what you're about and the members of your subcommittee are about and the reason that we're backing this bill is that this—what you are doing represents a partnership between the private sector and the Federal Government that is terribly important.

We face vigorous competition, and we must say that it's good solid competition from without, from the Japanese and from the Germans and from other societies, and it's good, healthy, vigorous competition. But this kind of successful partnership is extremely important if we are to go forward.

I entered this business 12 years ago. I was a partner of Dean, Witter, the investment firm, when I went into the venture capital business on a full-time basis. At that time, if you were at a cocktail party or a dinner and someone said, "What do you do?" and you said, "I'm in the venture capital business," their eyes glazed over, and there were no further questions. Thank you.

They had no idea what you were doing. That's changed. We've become a very trendy industry now. We are on the cover of Time and Newsweek. Walter Stults pointed out that Ambassador magazine, the in-flight magazine of TWA, has a profile on six venture capitalists in the recent issue.

So we are a very trendy business now, but that isn't going to necessarily remain the case, and it is very important for you—the Congress—to stay the course and continue to provide the SBIC backing that you're providing, because 5 to 10 years from now, you may find a number of these private firms that have been created in this very trendy atmosphere—and we've seen these things happen in the past—many of these private firms may disappear.

Therefore, the SBIC industry can continue to provide the backbone for private investment in small concerns. Of course, many of the private firms will continue to play significant venture capital-providing roles. Nonetheless, it is very important for the SBIC industry—this partnership between the Federal Government and the private sector—to remain healthy.

If I could, I would like to share with you very briefly just a couple of things that we have done in the Chicago area and in the Midwest.

We made an investment in 1977 in a company called American Antenna. It now employs nearly 100 people, has sales of $9.6 million, and makes 10 percent after taxes. The Elgin, Ill., market is well served by this company. It developed a new technology for a new antenna, a new state of the art, and it has been a very successful company.

A company called Heico, and this company is in Mendota, Ill., and two other similar companies—Lock Former in Lysle, Ill., and Dreis & Krump in the inner city of Chicago, I might add—are companies that I think provide good examples of the kind of investment that SBIC's, and perhaps only SBIC's, are going to make in today's world.

We refer to it in the trade as the leveraged buyout. In all three of those cases—the company in Mendota, the company in Lysle, the company in the inner city of Chicago—without SBIC financing, I doubt if those deals would have been done.

What's the net result? We've preserved over 1,500 jobs and we have taken three companies that were moribund and probably headed for chapter 11 or 10 or worse, and we made those companies viable, workable competitors in their market and strong competitors in the metal forming end of the machine tool company and in the computer control inventory retrieval system business.

And my testimony, Mr. Chairman, that we will send on to you will offer some backup on those companies. Together, they have sales of over $50 million. If it weren't for this kind of investment, and our causing the infusion of new, strong, and experienced management into those three companies, they simply wouldn't be here

today. For us as investors, it provided an economic opportunity for capital gain. We didn't do it because we were public spirited types; we wanted to make a buck, but we preserved those businesses and those jobs in the bargain.

There are other companies that are in the high tech end of our industry that we're involved in—a company like Intelligent Systems in Atlanta that from a standing start in 1973 now has sales of $20 million and is traded actively in the national over-the-counter market. It is profitable. It employs 220 people in the Atlanta market, and is a fast-growing company.

A company called NBI which I mentioned earlier, a company that today has sales of $57 million for the current fiscal year. It will have sales over $70 million this year, and we expect next year to have sales over $100 million. Tom Kavanaugh is the president. He was one of the founders of Storage Technology. It employs over 1,500 people and is a fast-growing manufacturer of word processors.

A company called Source Technology which employs 50 people; it has no sales, is less than a year old; and has developed the first intelligent microprocessor-based, dual projection system with its own sound system. In effect, it takes two Kodak slide projectors and a dissolve unit and a sound system, and puts them into a small enough box that it can fit under the seat of an airplane.

It will—the product—this is a commercial message—the product will be introduced in April and May.

Again, our SBIC is an investor in that company. With luck—knock on wood and fingers crossed—if we come back next year and the year after, that company, too, will be employing over 1,000 people.

Those are the kinds of businesses that we are proud to be associated with and, yes, we have an opportunity for capital gains, but we also feel that companies like this will enable us to compete with the Japanese and to compete with other societies and to do so in a healthy way.

I praise you for your involvement and your help and hope that this legislation will be successful. Thank you very much.

Mr. NOWAK. Thank you very much. If I just may ask you a couple of questions.

Mr. KOLDYKE. Yes.

Mr. NOWAK. Regarding the $35 million ceiling on leverage to any one SBIC, do you see that if that were removed, would that be a substantial help to accomplish some of the things that you have discussed in your very well articulated statement?

Mr. KOLDYKE. Well, Mr. Chairman, I agree that there are very few areas—I think that it's unfortunate SBA is opposing this legislation. Generally speaking, I think that this administration has taken a very positive attitude toward the private sector and toward business. It seems to me that this is one of the areas where a partnership between the Federal Government and the private sector, is working and should be further promoted.

Therefore, you and your colleagues, I think, are deserving of great praise for moving it forward.

Now, as to—specifically as to it, I agree with you. I think the $35 million cap ought to be dissolved and taken away simply because, as Mr. Ross pointed out the possibility exists that larger SBIC's

could be formed, and this cap, this ceiling is a deterrent to the formation of those new, larger SBIC's.

Mr. NOWAK. Let me ask you a question. Now, you talked about total dollars that we're dealing with here, and trying to raise the limit up to $250 million for the SBIC program. That's all the new ones and all the ones that are rolled over and so forth. When we look at what's happened with the structure of the economy very broadly and look at the money market growth over the last 1½ years or so, and the attractiveness of taking your dollars out of whatever investment you're in and putting them into a money market fund that pays 16 or 17½ percent as some of them did last year, without any real risk, I'm wondering how many venture capitalists are going to be out there with these kinds of offerings over a period of time.

We have seen a growth where, I believe, the last figures take us some place over $200 billion in money market funds that are out there. With deregulation coming and the rate structure remaining high, isn't this going to restrict your ability, whether as a private investment company or SBIC, to attract dollars in there to start these investments?

We've seen a home building industry that is virtually destroyed. We are going to have the rates for other big ticketed items always way up there. We are saying on the one hand we want to discourage consumption. I think we've effectively discouraged a lot of consumption by providing an alternate in the encouraged savings plans, and one of the big factors, of course, is the money market rate and the other interest rates that are so high.

But the fear now is, where are we going to get the people willing to risk and put money into venture capital opportunities since we have created this different structure that we're all living under. As far as I can see, you're never going to change that structure again. You're never going to go back to the kinds of rates that even for a $1,000 investment, you can get almost the highest rate that's out there. Won't this really make it much tougher to track money into the venture capital business?

Mr. KOLDYKE. Well, the recent experience in the industry in the last 2 or 3 years has certainly belied that, because there has been substantial new money, new pools of capital that have been created for venture investment.

However, I share your concern. When the spread between a virtually safe investment in a money market fund, compared to what you can hope to achieve by taking significant risk in the venture capital area, if that spread is reduced it is without question going to scare people or cause them not to want to be in the venture business. It just isn't worth the risk, if you're able to achieve 20 percent risk free. The difference between that and what you can achieve in the private sector by taking considerable risk and investing in small concerns. You have to wonder why you're doing that, why you're about that.

Mr. NOWAK. OK, and at least $2,000 tax-free, too.

Mr. KOLDYKE. Right, too.

Mr. NOWAK. Mr. Fary has been a member of this committee over the past 2 years and has attended meetings and has participated with us in all the different areas we've been involved in, including

the interest rate problem as it affects small business. He has really added great strength to the committee, not only by his attendance but by his participation in our caucuses. He's from Chicago, and I'm sure he'd like to say something to you.

Mr. FARY. Thank you, Mr. Chairman, and Mr. Koldyke. I'd like to thank you for your input in this venture capital issue, especially considering the fact that you are also from my home district of Chicago. Thank you very much.

Mr. KOLDYKE. Thank you, Mr. Fary. Thank you, Mr. Chairman. Are there any other questions?

Mr. NOWAK. We will anticipate your written testimony and we may get back to you at that time as we go through your testimony to develop any further questions and, again, if you can submit that within 10 days, we'd appreciate that very much.

Mr. KOLDYKE. Thank you.

[The prepared statement of Mr. Koldyke follows:]

PREPARED STATEMENT OF MARTIN KOLDYKE, GENERAL PARTNER, FRONTENAC CO., REPRESENTING NATIONAL VENTURE CAPITAL ASSOCIATION

Frontenac Company

208 South LaSalle Street Room 1900 Chicago, Illinois 60604 Telephone 312 368-0044

April 5, 1982

The Honorable Henry J. Nowak
Chairman
United States House of Representatives
Committee on Small Business
2430 Rayburn House Office Building
Washington, D. C. 20515

Dear Chairman Nowak:

The following summarizes my testimony on March 24, 1972 at the Hearing on H.R. 5302, the Small Business Venture Capital Act of 1981 before the Sub-Committee on Tax, Access to Equity Capital and Business Opportunities.

Mr. Chairman, my name is Martin Koldyke. I am a general partner of Frontenac Company, a venture capital investment firm in Chicago, Illinois. I am here today representing the National Venture Capital Association of which I am a Director, to offer the support of NVCA for H.R. 5302, the Small Business Venture Capital Act of 1981.

The NVCA has 124 members representing the non-SBIC private equity venture capital firms in the U.S. Member firms of NVCA have been investors in many hundreds of technology and non-technology small businesses. Some of our better known investments include such names as Apple Computer, Genentech, Storage Technology, Triad, Tandem Computer, NBI and Comserve, to name a very few.

Mr. Brent Rider, NASBIC's Chairman and Mr. Walter Stults, President of NASBIC, have in their prior testimony done an outstanding job of setting forth some of the more global concerns of the SBIC industry and why the specifics of H.R. 5302 should be supported in order to enhance the flow of capital to small, growing businesses from SBIC's.

In my testimony today I would like to leave with you several thoughts which I hope will be of interest. We are witnessing in the U.S. today a great awakening and awareness regarding high technology investment and its relationship to sources of venture capital. We have become a very "trendy" industry of late. In the past month both Time and Newsweek Magazines have had major articles on entrepreneurs and venture capital. TWA's inflight magazine, the current issue, has profiles on six venture capitalists. Word processors, micro-processors and biogenetic engineering are practically household words. This is good for the country. But it was not always so.

Twelve years ago when I co-founded our firm, people generally little knew, understood or cared very much about venture capital. What relevance does this have to H.R. 5302? I believe that the SBIC program is a stalwart mainstay for venture capital in this country. The program should be nurtured and supported. I indicated above that venture capital is a very "trendy" industry currently. Like all cycles, the current one will not last very long. Many of the private venture capital firms that have sprung up within the past three or four years may not stay the course over a longer period. In my view a healthy SBIC industry represents continuity and staying power for the future financing needs of small business.

Lastly, let me mention briefly a few of the companies in the Midwest and Pacific Northwest where we have invested our SBIC's funds in small companies that have created jobs and helped drive successful, small companies. Parenthetically, I should add that without additional available leverage in 1982 and beyond, our SBIC will be unable to make any further investments.

Here are some of the companies that we have supported:

> American Antenna, Elgin, IL, run by Mr. James Liautaud, an extraordinary entrepreneur. American Antenna was started in October of 1977, currently has annual sales of $9.6 million, is profitable and employs nearly 100 persons.
>
> Intelligent Systems, Atlanta, GA, Peter Curnin, President & CEO. We made an investment in September 1980. Founded in the mid-seventies, ISC now employs 220 persons, has annual sales of $18½ million and is one of the leading producers of color CRT terminals.

NBI, Boulder, CO., started by Mr. Tom Kavanagh, President & CEO. Prior to forming NBI, Mr. Kavanagh was one of the four founders of Storage Technology. NBI has annual sales of approximately $70 million and employs over 1500 persons. NBI is one of the leading producers of word processors in the world.

Another example of creative venture capital financing is that of Source Technology Corp., Seattle, WA. This is where a group of thoughtful inventors joined forces with creative venture capital investors and a businessman to create a company that will shortly be in production with the first micro-processor based dual slide projection system. The machine has its own built in sound system and is a programmable, intelligent unit. Already Source employs 50 persons in the Seattle area. The outside investors have already [illegible] $2.5 million that this is to be an outstanding success.

I could go on and on but I shall refrain from burdening you with additional examples. Thank you for your attention and for allowing NVCA to appear before you this morning.

Thank you Mr. Chairman.

Respectfully submitted,

Martin J. Koldyke

Mr. NOWAK. Thank you. This concludes the hearing, and the committee will stand in recess.

[Whereupon, at 11:42 a.m., the subcommittee adjourned to reconvene subject to call of the Chair.]

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